Economic Growth with Equity

Economic Growth with Equity

Which Strategy for Ukraine?

John Hansen
(the World Bank)

Diana Cook
(the International Centre for Policy Studies)

World Bank Discussion Paper No. 408

Manufactured in Ukraine
First printing October 1999

ISBN: 0−8213−4400−5

ISSN: 0259−210X

Library of Congress Cataloging−in−Publication Data has been applied for.

Contents

Acknowledgments

The inspiration for this paper came from conversations with the many talented Ukrainian counterparts with whom the authors worked during the participatory *Country Economic Memorandum (CEM) Project*, a participatory economic study co−lead by John Hansen (Economic Advisor, World Bank Office in Ukraine), Ihor Shumylo (Deputy Minister of Economy of Ukraine) and Vira Nanivska (Director of International Center for Policy Studies). The participatory process in Ukraine benefited from the guidance of a CEM Advisory Board composed of Mr. Vasyl Rohovy, Minister of Economy and Chair of the CEM Advisory Board, Prof. Anatoliy Halchinskiy, Advisor on Macroeconomy to the President of Ukraine, and the three co−leaders of the CEM process. Most of the preparatory and review work was done between June 1998 and June 1999.

Special thanks are due to Hafez Ghanem (Sector Leader, World Bank) for his encouraging us to develop our original notes into a formal paper. The authors also greatly appreciate the comments of William Easterly, Marek Dabrowski, Alex Sundakov, and the many others who participated in the formal review of this and other documents produced by the participatory CEM process.

The views expressed here do not necessarily reflect those of the reviewers or of the organizations for which the authors work. The authors remain solely responsible for any errors that may remain in this paper.

Abstract

Putting Ukraine back on the path to prosperity requires that policy makers stop letting economic crises dictate the policy agenda. Short−term problems need to be dealt with in the context of a longer−term strategic view focused on improving the living standards of Ukrainian people. What strategy should Ukraine follow? This report identifies and evaluates three sharply different alternatives, all of which are under active consideration today as Ukraine considers what to do after ten years of halting reforms and economic decline. These options for the future include (a) the Preservation Strategy, (b) the Protection Strategy, and (c) the Competition Strategy.

The *preservation* strategy, which is particularly popular among older people nostalgic for their way of life during the days of the Soviet, recognizes that it is neither possible nor desirable to return to the past, but seeks to preserve as much as possible of the state−dominated economic and social welfare systems of the Soviet era. The role of government would change little under this alternative. Neighboring Belarus is a good example of a country that has followed this strategy.

The *protection* strategy, which is particularly popular among both private and public sector industrialists, invokes the infant industry argument as a basis for throwing up trade barriers, providing subsidies, and extending tax privileges so that Ukraine's industrial enterprises —particularly those that are heavily energy dependent and technologically out−of—date can survive without having to face pressures from internationally competitive enterprises. The protection strategy, which has been popular in many countries, was followed with particular vigor by the Latin American countries in the 1960s and 1970s, for example.

The *competition* strategy enjoys support particularly among the modern Ukrainians who know that their country, with its highly developed industrial structure, has always been very outward−oriented and trade−dependent. They want to see Ukraine become a prosperous European country based on the same market principles that have brought wealth and prosperity to the European Union, East Asia, and many other parts of the world.

Each strategy is evaluated in terms of its probable impact on fiscal balances, inflation, the current account deficit, economic growth, employment, and equity. The report recognizes that, in the real world, all countries including Ukraine will adopt some blend of these three stylized models. But based on the analysis of the probable consequences of these models for the Ukrainian people, this note concludes that strategic economic policies for Ukraine should be based as fully as possible on the competitiveness model. Although implementing it will involve some difficult transitional problems, it is the only vision for the future that holds promise of sustainably higher levels of income for all Ukrainians.

1—
The Need for an Economic Strategy

Ukraine's economy has been slipping backwards for nearly a decade, resulting in a significant fall in the living standards of the Ukrainian people. Putting Ukraine back on the path to prosperity will require policy makers to stop letting economic crises dictate the policy agenda. Short−term problems need to be dealt with in the context of a longer−term strategy.

Dealing with Depression

Ukraine is a country of great potential. But it has endured one of the world's worst depressions in modern history. The impact of declines in GDP on the people of Ukraine has been acute.

Ukraine is a country of great potential, blessed with well−educated people, abundant natural resources and a tradition of hard work in industry and agriculture. Its geographical location in the heart of Europe leaves it in a good position to benefit from world trade. At independence, Ukraine was widely considered to have excellent prospects.

Instead Ukraine has endured one of the world's worst depressions in modern history. That depression has lasted for nearly 10 years and has reduced gross domestic product (GDP) by over 60%. Even among the countries of the former Soviet Union, Ukraine stands out as having one of the deepest and longest periods of economic decline (Figure 1).

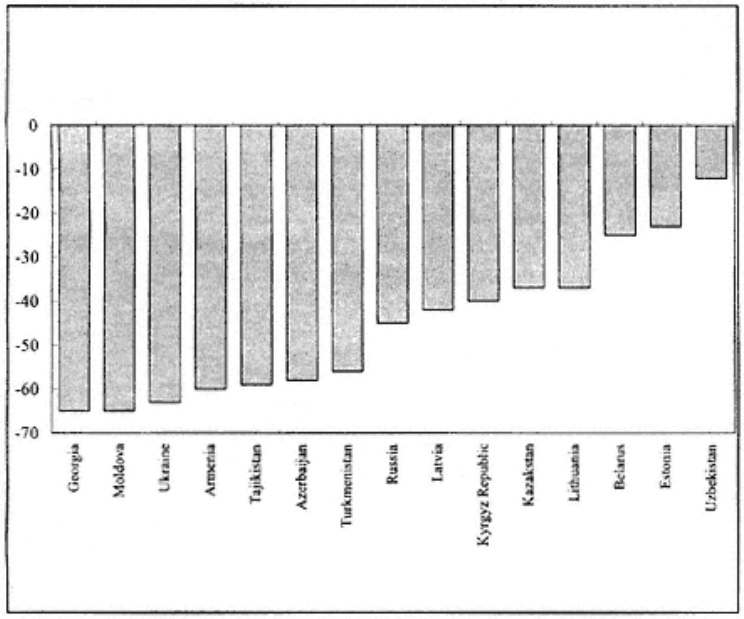

Figure 1
Cumulative Economic Decline for FSU: 198996
Source: World Development Indicators

Although the economy seemed to have stabilized by mid−1998, the crises of Asia and Russia now threaten this hard−won stability. With limited signs of real growth for the economy as a whole, the hard−won stability now looks more like stagnation.

The impact of declines in GDP on the people of Ukraine has been acute. They must now live on less than half the income they enjoyed a few short years ago. At least 30%, and perhaps up to 75%, of families now live below the poverty line, up sharply from the time of independence.1 Their savings accounts were wiped out by the hyperinflation of 199293. Sickness from preventable causes is rising, death rates are climbing, life expectancy is falling, and the population is shrinking. Although the collapse in industrial production has somewhat reduced environmental pollution, the levels still far exceed the standards of countries not suffering from the environmental neglect of the Soviet past. In addition, the people of Ukraine still must deal with the aftermath of the Chernobyl disaster.

Economic Policy Without Vision

Ukraine has become bogged down in "fire−fighting" and has lost sight of its overall objectives. As a result, Ukraine has stumbled from one crisis to another.

Why has Ukraine not been able to take advantage of its great potential? The problem is that Ukraine has become bogged down in "fire−fighting" and has lost sight of its overall objectives. While the President and Government have articulated a general medium term direction for economic policy, policy implementation bears little resemblance to that vision. As a result, Ukraine has stumbled from one crisis to another. The recent economic history of Ukraine illustrates this problem.

The initial years after independence were characterized by large budget deficits as the Government vainly sought to support declining enterprises and industries (Figure 2). These deficits were financed largely by borrowing from the central bank and the resulting hyperinflation contributed to the uncertainty facing potential investors.

In the middle of 1994, recognizing the costs of inflation, the Government began to rely less on the National Bank to finance its deficits and the majority of the deficit was financed through borrowing. It also made a major effort to reduce the budget deficit, which fell to just over 4% by 1996. Inflation dropped from the hyperinflationary levels of 1992 and 1993 to a modest 10% in 1997. The nominal exchange rate, which had devalued by over 400 times between the third quarter of 1992 and December 1994, has been more or less stable since mid−1995.

However, the Government was so overwhelmed by the need to stabilize the economy, it seemed unable to step back and address the underlying problems. A more fundamental problem was that Ukraine's ability to

1 See: *"Ukraine: Restoring Growth with Equity"—Country Economic Memorandum* .

produce goods and services had fallen since the collapse of the Soviet economy. The weakness in the economic outlook reflects a fall in productive capacity, and a continuing decline in GDP during 1998 was matched by a resurgence in inflation. The combination of falling GDP and rising prices suggests that Ukrainian enterprises are not able to produce the goods and services that Ukrainians and foreigners want to buy.

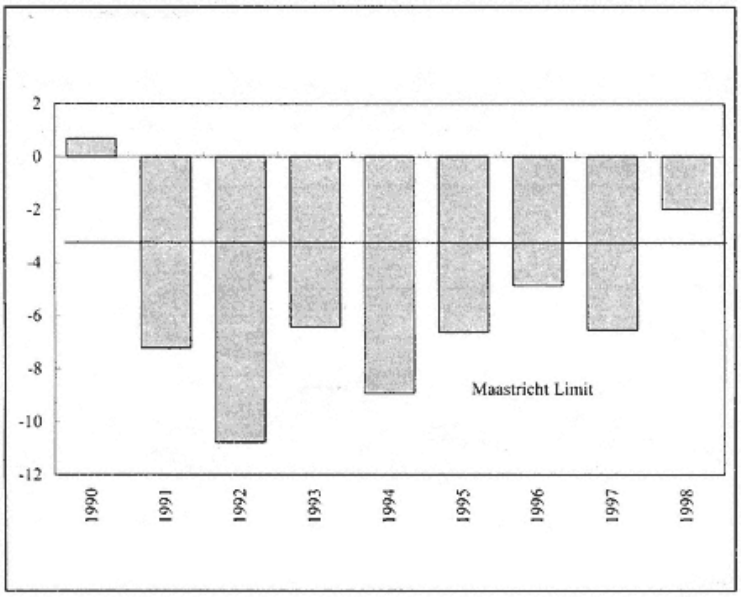

Figure 2
Consolidated Budget Balance, % GDP
Source: Ministry of Finance of Ukraine

There are a number of explanations for this fall in Ukraine's productive capacity. With the collapse of the Soviet Union, increases in energy prices raised the cost of doing business especially in the highly energy intensive Ukrainian economy. The move to world prices worsened Ukraine's terms of trade with Russia, its main supplier of raw materials. Perhaps most importantly, the economy had been caught between a planned and a market economy without a clear economic system for allocating resources. This has been reflected in the continued growth of indirect subsidies, such as tax exemptions, the shadow economy and arrears.

As a result, financial stability did not bring economic growth. These problems continued to undermine economic activity, despite the government's fiscal reforms, putting renewed upward pressure on spending and shrinking the government's tax base. The deficit shot up to almost 7% of GDP in 1997. The combination of tight monetary policy and growing fiscal deficits lead Ukraine into a classic debt trap. With inflation running at about 10%, real interest mates were exceeding 60% by late 1998 (Figure 3). As a result, the 1998 crisis in Russia caught Ukraine

in a vulnerable position.

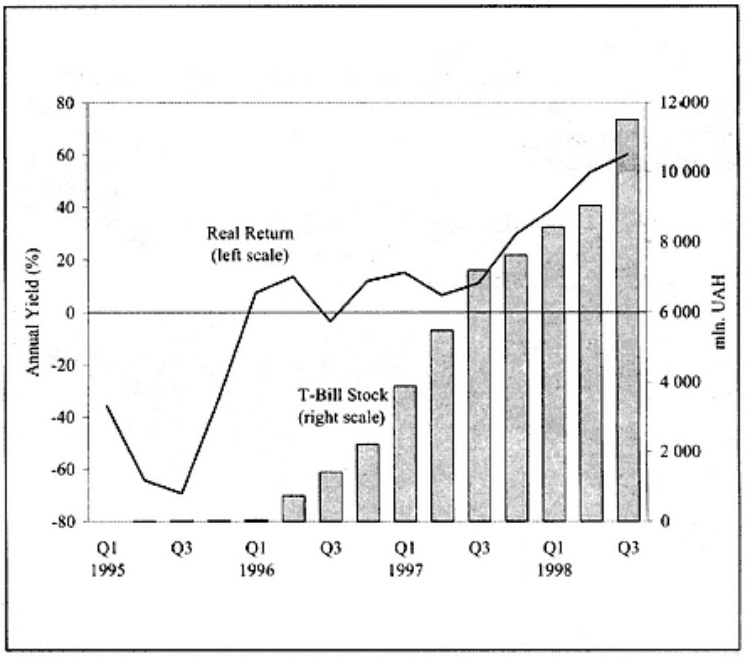

Figure 3
Ukraine: T−Bills
Source: Bank staff estimates

Ukraine's recent experience highlights the dangers of not addressing economic problems in the context of a wider economic strategy. Expenditure cuts to reduce the deficit were not sustainable without policies to change the role of government in the economy, to reduce structural inefficiencies, to move shadow activity into the formal economy and to improve the productive capacity of Ukraine. Therefore, this report seeks to identify a strategy for putting Ukraine back on the road to economic prosperity. It begins by clarifying the objectives of economic policy (chapter 2), then evaluates alternative strategies for achieving those objectives (chapters 37) and, based on this analysis, develops a recommended strategy (chapter 9).

2—
Economic Growth with Equity

Before developing a strategy for economic and social policy, Ukraine needs a clear idea of what it wants to achieve. Alternative strategies need to be evaluated in terms of their success at getting Ukraine where it wants to be. What does Ukraine want to achieve? The ultimate objective of public policy is to raise the living standards of the Ukrainian people. Policy makers are concerned with the overall economic welfare of Ukrainians and in how that welfare is distributed amongst the population.

Economic Growth

Living standards are ultimate objective of economic policy. The level of real GDP is a good gauge of economic prosperity. Public deficits, inflation, the current account balance, and employment are important measures of the sustainability of economic growth.

It is important to keep in mind when designing economic policy that living standards are our ultimate objective. Therefore, the subsequent chapters evaluate alternative economic strategies in terms of the impact on Ukrainian living standards, both in the immediate and more distance future. Sometimes policy makers will face trade−offs between maintaining economic activity in the short term and setting the background for sustainable economic growth. While short term consequences are important, they should not be the sole drivers of economic policy.

The level of real GDP is a good gauge of economic prosperity, and growth in real GDP is a good gauge of economic progress. In particular, for policy makers concerned about living standards, GDP per person is an important measure of economic well being. It tells us about the quantity of goods and services available for the typical person in the economy.

While policy makers are ultimately concerned about living standards, they often worry about other economic variables like the public deficit, inflation, the current account balance, and employment. These indicators are important measures of the sustainability of economic growth and improvements in living standards. In particular:

International experience has indicated that very high levels of inflation are generally harmful to economic growth. In particular, high levels of inflation can discourage savings and investment. Some countries manage to attain quite respectable rates of growth despite inflation. In fact, up to about 25% per year, there is little correlation between inflation and economic growth (Figure 4). However, beyond this level growth generally drops off quickly.

A large current account deficit means that a country is spending more than it is earning. The gap between the two is financed by foreign lending and investing. But we can not continue to spend more than we earn forever. As the current account deficit gets bigger, foreign

lenders and investors become increasingly nervous about the ability of a country to repay them and about the stability of the exchange rate. They impose high interest rates to compensate them for this risk. In the extreme case, investors may actually flee the country, pushing the value of the domestic currency down and interest rates up. High interest rates stifle economic growth by discouraging consumption and investment. Over time, exports recover and imports ease, bringing the current account back into balance.

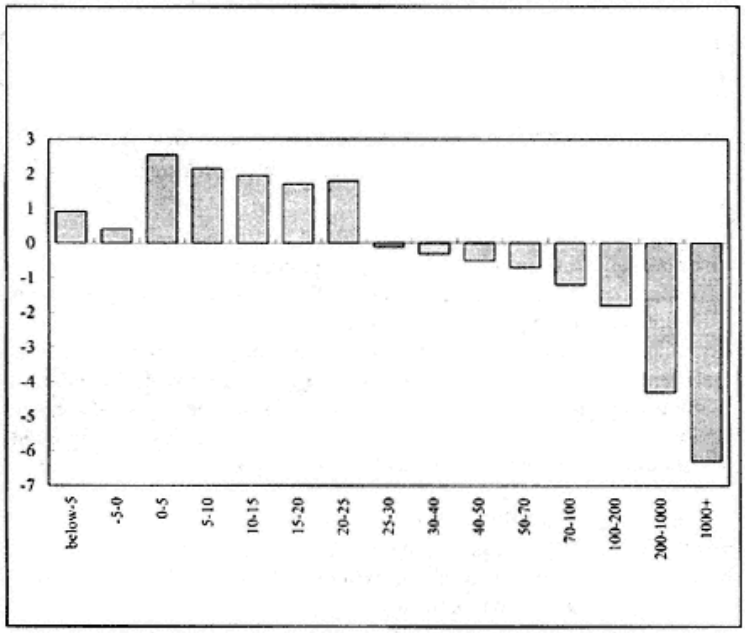

Figure 4
Annual Inflation and Per Capita Growth Rates, 196092
Source: Easterly and Fisher, 1994

Persistent fiscal deficits can also be a constraint to economic activity. By reducing national savings, budget deficits translate into increases in real interest rates and falls in investment. Reduced investment leads over time to a smaller stock of capital, reducing the ability of the economy to produce goods and services. In addition, the build up of debt must eventually be repaid implying an increase in future tax rates or a cut in future government spending. Either way, inheriting a large government debt lower is the living standards of future generations.

Access to employment or paid work is an important determinant of the welfare of Ukrainian people. In addition, people are an important resource. If a growing number are not utilized, this is a significant constraint on Ukraine's ability to grow.

We are not interested in these variables for their own sake but because of their impact on economic activity or standards of living. Predicting the consequences of alternative economic strategies for these variables can help assess whether the strategy can deliver sustainable economic growth.

Equity Not Equality

Policy makers are not only concerned about the size of the pie but also about how that pie is distributed. Our definition of equity implies the existence of a safety net to ensure that the incomes of the poorest Ukrainians do not fall below a minimum level.

Of course policy makers are not only concerned about the size of the pie but also about how that pie is distributed. In this case, we are likely to be concerned about the level of employment, or unemployment, for its own sake. Employment provides a link between economic growth and equity objectives. Improved employment opportunities is one of the key ways that the benefits of economic growth are delivered to the average Ukrainian person. If our economic strategy delivers robust economic growth but high levels of unemployment, large numbers of Ukrainians would not be sharing in the economic success.

Evaluating the equity of a strategy is more difficult than evaluating its impact on economic growth. Equity relates to the fairness of the distribution of well−being among the members of society. But defining fairness involves normative judgments that go beyond the realm of economics and enters into the realm of political philosophy.

Therefore, it is important for policy makers to think carefully about what their equity objectives are. We suggest that equity is not the same thing as equality. Some increase in income inequality is completely normal, even desirable, as countries move from the artificial equality of the soviet system to a system where income inequalities provide incentives for people to get more education, work harder, and take on more responsibility. It is equitable for people to be rewarded for working hard, for investing in education or for taking entrepreneurial risks.

While equity may not mean equality of outcomes, this report assumes that it does mean equality of opportunity; for example in access to education. We also suggest that the state has a role to play in protecting the most vulnerable in society. Our definition of equity implies the existence of a safety net to ensure that the incomes of the poorest Ukrainians do not fall below a minimum level.

3—
Choosing the Right Road

Given the objective of raising living standards, what strategy should Ukraine follow? We identify three different alternatives for Ukraine: the preservation strategy, the protectionist strategy or the competitiveness strategy.

Ukraine stands at a crossroads. Past policies have produced apparent economic stability but no growth. Sharply different roads are under discussion today for Ukraine's future. What direction should Ukraine head to seek a prosperous future?

The following chapters examine the probable consequences of three basic strategic options for Ukraine: (1) the preservation strategy, (2) the protectionist strategy, (3) the competitiveness strategy.

Ukraine faces a number of options. Indeed, the possible combinations of policy strategies from which Ukraine could chose are endless. To facilitate the discussion of alternative strategic choices, the following chapters examine the probable consequences of three basic strategic options for Ukraine:

The preservation strategy . Should Ukraine pursue growth by preserving as much as possible of the status quo to avoid social problems? This would involve maintaining a major role for the government in production while moving only cautiously towards private enterprise.

The protectionist strategy . Should Ukraine seek growth by protecting its domestic farms and factories from excessive competition? This would involve implementing protective measures designed to stimulate domestic production within a relatively closed, self−sufficient market economy.

The competitiveness strategy . Or should Ukraine pursue growth by creating an open market economy and encouraging competition. This would involve removing barriers to competition and limiting the Governments role to facilitation rather than ownership and participation in production.

Each of these policy directions has worked for at least some time in various countries. There is no absolutely "right" or "wrong" answer to these questions. Each path could conceivably produce improved living standards in Ukraine someday, at least for a while. The strategy that Ukraine ultimately chooses will almost certainly, as in every other country, be a blend of these strategies. However, one of these strategies is likely to dominate. In choosing what strategy should dominate, it is vitally important to understand the probable consequences of each strategy for future living standards in Ukraine.

The following discussion draws on economic theory, international experience and Ukraine's own experience since independence in trying to predict the probable consequences of following the preservation, protection, and competitiveness strategies. Each strategy is evaluated in terms of the following criteria:

The fiscal deficit and, more broadly, the role of government in the economy.

Inflation

The current account deficit.

Improvement in overall living standards or economic growth.

Employment.

Distribution of income.

However, before we turn to this evaluation, we need to discuss briefly an option not mentioned above. This is an option that many people in Ukraine today consider very attractive: returning to the past.

4— Returning to the Past: A Non−Option

Returning to a command economy is not a realistic option for Ukraine. The economic and political factors that led to the downfall of communism have not disappeared. In addition, Ukraine no longer enjoys the implicit subsidies that helped support centralized decision making under the Soviet Union.

Each of the three strategies listed in chapter 3 recognizes that some form of market economy must be developed to replace the old command economy. Even in Belarus, where the authorities are pursuing a very cautious pace of reform, almost everyone, including the President, recognizes that the country will have to depend on some form of market−based economic organization. There are at least four reasons why a return to the past is not a viable option:

Inherent inefficiency.

The rise in energy prices.

The end of inter−republican subsidies.

Globalisation.

Inherent Inefficiency

The old command−and−control system was inherently inefficient and collapsed of its own internal weaknesses. The system was supported by the immense natural resources of continental Russia. In contrast, the Soviet system grossly underutilized the region's most valuable resource: its people.

The old command−and−control system was inherently inefficient and collapsed of its own internal weaknesses, as the economy became more sophisticated. In the fairly simple, largely agrarian society that existed in the early years of the Union of Soviet Socialist Republics, a relatively small group of centralized bureaucrats could make basic decisions without great inefficiency.

However, as the economies of the FSU became increasingly complex, centralized decision−makers lacked the information they need to make good decisions about production and distribution. The decisions to be made regarding investment priorities, sources of materials, production methods, labor management, and marketing became increasingly specific to individual, specialized lines of production. These information problems led Soviet authorities to direct an ever−higher share of national income into investment that, in the end, added almost nothing to output (Figure 5).

The Soviet system survived as long as it did partly because a lot of good people tried very hard to make the system work. Even more importantly,

the system was supported by the immense natural resources of continental Russia. A price of this survival was massive and perhaps irreparable environmental damage, as wealth was stripped from mines, oil and gas fields, forests, waterways, and agricultural land in order to support the failing Soviet system.

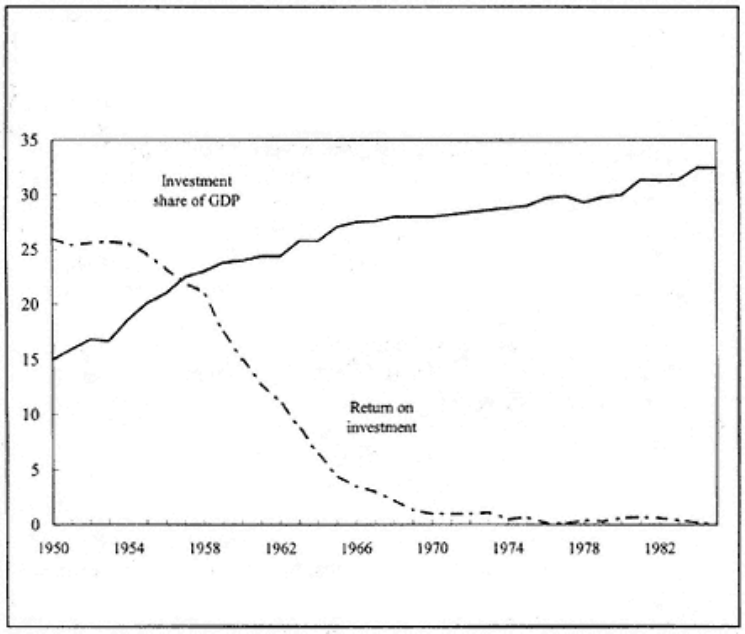

Figure 5
Investment and Rates of Return in Soviet Industry
Source: World Bank, World Development Report, 1996

In contrast, the Soviet system grossly under−utilized the region's most valuable resource: its people. By centralizing decision making, the system "dis−empowered" the talented, well−educated people of these republics. People working daily in farms and factories were in the best position to make production decisions. They knew what really needed to be done to improve productivity, but were not allowed to put the fruits of their knowledge and understanding to full effect. Nor were they given the incentive to press for improvements. And it was the state, as owner of virtually all productive assets, that reaped the benefits.

The result was an increasing impoverishment of the people who, towards the end of the regime, were forced to stand in long lines even for the necessities of life and who were paid in money for which there were no goods. (It is ironic to note that today, in the virtualised economies, the opposite problem has developed. People are paid in goods for which there is no money.) While many people had large savings accounts, the money was almost worthless as the economy could not produce or import enough goods to meet the demand represented by that money.

In an economy without controlled prices, the money printed to pay workers under the Soviet system would have caused inflation. The rising prices would have balanced the supply of money with the physical supply

of goods. That was not allowed to happen until the break−up of the FSU. When price controls were removed, inflation surged, destroying the value of household's savings.

Energy Prices

The sharp increase in energy prices also prevents a return to the past. The energy intensive Soviet system can not survive using energy costed at full value.

The sharp increase in energy prices also prevents a return to the past. Under the Soviet system Ukraine had access to artificially cheap energy supplies. For example, hydrocarbon energy supplies, such as oil and gas, were priced for domestic production at about one−tenth of the prevailing world prices. Energy was also grossly under−priced in terms of the environmental damage it created during extraction, transport and use. The damage was most notable—or to be more precise, devastating—in the case of the Chernobyl disaster. Residual liabilities of this era are still found throughout the region, including in Ukraine in terms of dangerous nuclear plants, many which are still operating, and tons of nuclear waste.

The energy intensive Soviet system can not survive using energy costed at full value. As Ukraine is not energy self−sufficient and must import fuel at world prices, it has to follow a strategy that forces the efficient use of energy.

Inter−Republican Subsidies

Ukraine can no longer depend on the massive inter−republican subsidies that once helped disguise the inefficiencies of the Soviet system.

A return to the past is also impossible because Ukraine can no longer depend on the massive inter−republican subsidies that once helped disguise the inefficiencies of the Soviet system. The most important of these subsidies has already been noted — Ukraine's access to energy at prices far below world market levels. But Ukraine also depended on other subsidies that were indirectly financed by the vast natural resource wealth of Russia. The best example is probably the large and very sophisticated defense industry that the Soviet Union developed on Ukrainian soil. The tanks, aeroplanes, and rockets that Ukraine produced were paid for by the Soviet military machine which in turn was fed by a government that exploited a vast base of natural resources. This implicit subsidy of military, which once accounted for around one third of total Ukrainian industrial output, has come to an end. Ukraine can no longer rely on guaranteed Russian markets and must develop new markets for its products.

Globalisation

The globalisation of the world is a fourth reason why Ukraine can never go back to a Soviet system. With instant world−wide communications, rebuilding an Iron Curtain that keeps average people more or less ignorant of life in the rest of the world would be virtually impossible today. In fact, modern communications were instrumental in bringing down the former Soviet Union. Attempts to impose soviet−style controls, including the limitation of consumer choice, would quickly meet with widespread opposition today.

For Ukraine to cut itself off from participation in global economic markets would be an economic disaster. Ukraine has always depended heavily on international trade. Even during Soviet days, total trade turnover (imports plus exports) was equal to 50% to 60% of GDP, a figure that today stands at 90% to 100%. This increase reflects the increased openness to global markets and the fundamental realignment of the exchange rates used to value trade relative to GDP.

Pre−industrial, self−sufficient agrarian economies can shut themselves off from international trade. But Ukraine with its sophisticated industries needs a global market to maintain economic scales of production in these highly technical and competitive products.

Pre−industrial, self−sufficient agrarian economies can shut themselves off from international trade. But this is impossible for a country like Ukraine with sophisticated industries such as aeroplanes, rockets, tanks, iron and steel, and chemicals. Ukraine needs a global market to maintain economic scales of production in these highly technical and competitive products.

Ukraine Can Not Go Back

These reasons highlight that it is impossible to recreate an economy in Ukraine based on centralized controls and administrative fiat. The old centrally controlled soviet system proved incapable of dealing efficiently with the complexities of a modern industrial economy. It also proved incompatible with the existence of the basic democratic freedoms and responsibilities that are so important to people everywhere in the world, including the people of Ukraine. Some form of market economy where resources are allocated and production decisions are made by individuals on the basis of prices, rather than by bureaucrats on the basis of state plans, is the only solid foundation for a modern Ukraine. Therefore, Ukraine can not go back. But in which direction should it go forward?

5—
The Preservation Strategy

"Belarus is an example of how to preserve the best of what was previously present (in the Soviet Union)—something that positively influenced its economic development".
—O. Tkachenko, 28 January 1999.

The preservation strategy involves a slow movement towards a market economy with the greatest possible maintenance of the status quo. Under this strategy, Government maintains existing structures of ownership and control and seeks to preserve the social benefits of the Soviet regime.

Advantages:

The maintenance of subsidies to agricultural and industrial enterprises avoids the sharp initial drop in production and employment that would result from their removal. Maintaining the status quo also reduces social stress and political tensions.

Disadvantages:

Long term growth prospects are damaged by the continued support of inefficient production and the cost of financing high government spending. This results in high interest rates, scarcity of working and investment capital, banking system instability, external payments problems, enterprise losses, mounting arrears in wage and social payments, rising unemployment, and inevitably, falling living standards.

The Strategy

The preservation strategy is based on the premise that the Government can preserve the social benefits of the Soviet regime while still moving towards a market−based economy.

The preservation strategy is based on the premise that the Government can preserve the social benefits of the Soviet regime while still moving towards a market−based economy. To avoid enterprise closures and lay−offs, Government provides extensive support to enterprises so that they can continue working and providing employment despite low sales and losses. Also, to avoid conflicts with groups such as the managers and workers

of state enterprises and collective farms, and with government officials, the government should seek to preserve the existing structures of ownership and control.

This strategy is being pursued with particular vigor today in this region by the authorities in Belarus. Similar strategies have also been followed in the past through out the world, most notably in the totalitarian states of Africa and Latin America.

However, the strategy has not been limited to countries with totalitarian governments. Essentially similar policies have been followed in the past by more populist but still centrally−controlled governments such as those in Nayerie's Tanzania, Allende's Chile, Garcia's Peru, and Peron's Argentina.

Evaluating the Preservation Strategy

In this section the impact of the preservation strategy is predicted and evaluated in terms of the criteria we identified in section 2 and 3. Although no one can be certain what the future consequences of any specific strategy will be, evaluating the recent experience of Ukraine gives a good idea of the probable consequences of the preservation strategy, for many of the policies that Ukraine has followed since independence fit comfortably within the preservation strategy.

At the same time, it would be wrong to describe Ukraine's overall policies to date as "status quo preservation". In areas such as privatization of small and medium enterprises, introduction of its own national currency, establishment of a more modern system of taxation, and development of the governance structures of an independent nation, Ukraine has clearly been leaving the past behind. But in other areas Ukraine has tended to preserve the status quo. These include the structure of agriculture, the ownership of large enterprises, the development of a modern framework of laws and institutions, and foreign trade policies.

Fiscal Position

A preservation strategy implies no significant revision of government spending or of the role of government in Ukraine. To preserve the current size of government relative to GDP, the government will either have to run large deficits or increase tax rates.

A preservation strategy implies no significant revision of government spending or of the role of government in Ukraine. The government would maintain current employment levels in the public sector and spending in social areas, such as health and education. It would also continue to play a large role in subsidizing enterprises through direct payments and tax concessions. To preserve the current size of government relative to GDP, the government will either have to run large deficits or increase tax rates.

Any effort to close the budget deficit by increasing tax revenues would fall heavily on the production of goods and services. Taxation on production in Ukraine is estimated to have accounted for about 73% of total tax revenues in 1998. The tax burden on legal enterprises is exacerbated as about half of all economic activity in Ukraine hides in the shadow economy where it is not taxed. Of the other half of enterprises, about half are not profitable. Thus, in terms of corporate profit tax, the burden falls on about one quarter of all economic activity. Increases in taxes would further erode the profitability of potentially viable enterprises, reducing their ability to invest and grow. This would drive more enterprises into the shadow economy.

If instead the Government finances the current level of expenditure through deficits, the consequence will be a continued high cost of capital

for private enterprises. It is largely because of high budget deficits that investment capital in Ukraine is both scarce and extraordinarily expensive. This can be very costly for economic growth, particularly in the longer term. Investment is an important source of future growth and productivity through its contribution to the nation's capital stock.

If the Government continues to run high budget deficits, it will be forced to borrow at an increasingly high cost, until it can no longer afford to pay its debt servicing obligations. At that point, the Government would be forced to restructure its debts, effectively cutting it off from further borrowing abroad. Meanwhile, the severe scarcity of capital in the domestic market would make further borrowing there extremely difficult, forcing the government to default on its payment obligations and to accumulate arrears. These risks are obviously not theoretical. In fact, such problems are already quite visible in Ukraine today.

Inflation

As borrowing becomes increasingly difficult and costly, the government would again resort to printing money as it did in the early 1990s.

There is another way that the government could finance its deficits. It could borrow from the central bank by printing money. Under the preservation scenario, it is likely that the government would come under increasing pressure to do just that. As borrowing becomes increasingly difficult and costly, the government would again resort to printing money as it did in the early 1990s.

The borrowing may be small at first, taking the form of residual central bank purchases of t−bills that did not sell in the t−bill auctions, something that has been happening with great regularity since the crisis of late 1998. Borrowing from the central bank would gradually become more visible and important relative to the bank's total assets, making it difficult for the Government to remain in compliance with IMF ceilings on net domestic assets. The sale of foreign exchange would offset part of the monetary emission, but once reserves fall to dangerously low levels, IMF conditions would be breached. This would prompt the World Bank to cut off its lending, making the situation even more acute. With no access to domestic or foreign borrowing, and with public sector employees and pensioners clamouring to be paid, the Government would have any choice but to begin large−scale monetary emission, thus triggering another round of hyperinflation.

If domestic inflation exceeds the pace of inflation in trading partner countries, Ukraine will come under pressure to further devalue its exchange rate. During the hyperinflation of 199394, Ukraine devalued sharply. This was not enough to offset inflation, during 1993 the real rate appreciated sharply. In 1994, however, the real rate began to stabilize and even depreciated, reversing part of the earlier real appreciation (Figure 6). Allowing the nominal exchange rate to depreciate in the face of rapid domestic inflation preserved Ukraine's competitive position, but aggravated an already unstable price environment, making investment deci−

sions very risky. Clearly less inflation would have been highly desirable, allowing the nominal and real exchange rates both to remain more stable.

If Ukraine tries to keep a "stable"' exchange rate as a "nominal anchor" to stabilize the economy, the results are likely to be disastrous unless the country pursues equally tight fiscal policy. If fiscal policy remains loose and the exchange rate remains relatively fixed, inflation will make Ukraine's goods increasingly uncompetitive in foreign markets.

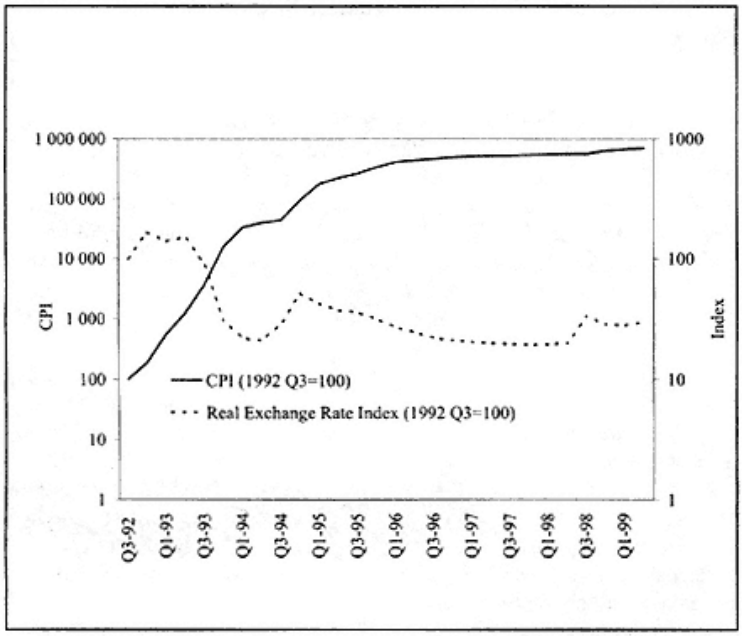

Figure 6
Ukraine: Real Exchange Rate Index and CPI
Source: National Bank of Ukraine

Indeed, if Ukraine does want to maintain a steady exchange rate, the best approach is to maintain firm fiscal and monetary policy. If a country has limited deficit−financing requirements, the pressure to expand monetary emission will be modest, inflation will be low, and the exchange rate will naturally tend to be stable in the absence of strong exogenous shocks, such as a major change in oil prices.

Current Account Deficit

If a preservation strategy involves policy makers attempting to keep the exchange rate stable in the face of high rates of inflation, the current account implications are not rosy. Ukraine is already experiencing current account problems. However, these can not all be attributed to the preservation strategy. In fact, Ukraine's earliest external payments problems were the result of developments over which it had almost no control:

The loss of traditional markets that came with the break−up of the former Soviet Union.

The sharply higher energy prices that resulted from Russia's decision to begin exporting its abundant energy resources at international prices.

If a preservation strategy involves policy makers attempting to keep the exchange rate in the face of high rates of inflation, the current account implications are not rosy. As the strategy leads to growing government deficits, the current account deficit will also become wider.

However, the loss of traditional markets and the oil price shock were common to all republics of the former Soviet Union. Many adjusted more quickly and more successfully than Ukraine. For example, the Baltic States quickly compensated for the higher energy costs and the loss of traditional markets by improving production efficiency and developing new markets.

In contrast, Ukraine has failed to adjust successfully to the loss of traditional markets and to develop new products and markets. As a result, the merchandise trade balance has deteriorated from a surplus of nearly USD 2 billion in 1991 to a merchandise trade deficit of over USD 4 billion in 1996 and 1997. A somewhat smaller deficit was realized for 1998, but this is more the result of the sharp decline in imports resulting from the problems in Asia and Russia than success in stimulating exports. Merchandise exports, in fact, are expected to decline significantly compared to 1997.

While we can discuss the current account deficit as the difference between imports and exports, it is also important to remember that the deficit represents the difference between national savings and investment. The only way to invest more than domestic savings is to access the savings of the rest of the world. This has been the case in Ukraine during the past several years. While investment has been weak, domestic savings have been even weaker. Budget deficits have been a significant driver of the weak national savings. The negative saving of government has significantly reduced national savings and contributed to the widening current account deficit.

Government foreign borrowing also puts upward pressure on the exchange rate. This exacerbates the current account problems by making Ukrainian goods and services less competitive relative to foreign goods. High government debt makes foreign investors increasingly nervous about investing in Ukraine. This helps explain the extraordinarily low level of foreign direct investment in Ukraine compared to other countries in the region (Figure 7).

As the preservation strategy almost inevitably leads to growing government deficits, the current account deficit will also become wider. If a nation is using foreign capital to build its productive capacity, the resulting current account deficit is of less concern because the investments will generate a return to repay foreign lenders and investors. However, if Ukraine borrows to finance consumption, it will ultimately have to reduce future living standards to repay this debt.

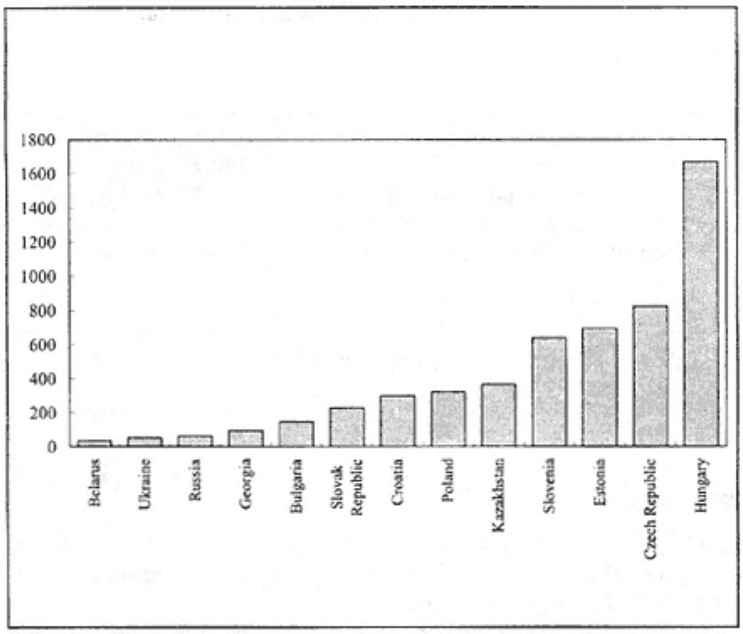

Figure 7
Cumulative FDI−inflows 198997 per capita in USD
Source: National Bank of Ukraine

Economic Growth

Perhaps the most harmful element of the preservation strategy for economic growth is the lack of hard budget constraints. This has removed the incentive for producers to look for ways to raise productivity and minimize costs. It has also reduced the movement of resources to those enterprises that could use them most effectively.

Employing elements of the preservation strategy helped the Ukrainian people avoid sharp reductions in living standards in the early years of independence. The subsidies to agriculture and industry maintained production, and thus the incomes of workers, despite the severe shocks caused by the break−up of the former Soviet Union.

However, our evaluation suggests that this maintenance of living standards was accomplished at the cost of future economic growth. As discussed above, the large government sector will continue to inhibit economic growth no matter how it is financed. But perhaps the most harmful element of the preservation strategy for economic growth is the lack of hard budget constraints. This has removed the incentive for producers to look for ways to raise productivity and minimize costs. It has also reduced the movement of resources to those enterprises that could use them most effectively (Box 1).

Hard budget constraints mean that all institutions, including government, enterprises and households, have to pay for what they consume. Furthermore, they can not consume more than they can earn or borrow on a sustainable basis. Hard budget constraints force individuals, enterprises, and governments to make hard decisions about priorities, thus maximizing the efficiency of resource use and economic growth. In the production sector, the arrears that have built up because enterprises are unable to pay their workers, suppliers, bank loans, and taxes is clear evidence that the enterprises are not living within their means.

If individual, enterprises, and government bodies do not live within their means and pay for what they use, prices become irrelevant. If an enterprise does not pay its electricity bill, a price of $40 per thousand kWh is simply an illusion. The real price is zero. If the real price is zero, the enterprise will make no effort to reduce its energy consumption. If the worker does not get paid, the wage is not UAH 100 per month. The real wage is zero. At that price, the enterprise will preserve existing staffing levels, thereby avoiding the uncomfortable process of laying off workers, a process that would encourage them to look for more productive employment.

Box 1 Belarus: a Success Story for the Preservation Strategy?

Proponents of the preservation strategy often point to Belarus as evidence of the success of taking the transition from the command to market economy slowly.

Economic growth reached 11% in 1997, and despite a serious slump in trade with Russia towards the end of the year, growth in Belarus in 1998 was still about 10%.

But it's hard to reconcile these figures with the fate of the average Belarusian. A survey by the scientific research institute of the Ministry of Economy shows that people's expectations have become steadily worse over the last two years. In the fourth quarter of 1996, 46% of people expected the material status of their family to get worse over the next six months. By late 1998, during this so−called miracle of 10% growth, the share had increased to 78%. By early 1998 even President Lukashenko demanded to know from his Cabinet why living standards were getting worse despite the economic growth.

In short, economic growth does not appear to be translating into improved living

standards for the Belarusian people. Why not? Unfortunately, this success is not real. Official GDP appears high because of a system of barter and non−payment, where the prices are artificially high. Belarusian enterprises, using materials that they have taken on credit from abroad and using National Bank loans, are manufacturing products whose real prices are lower than the cost of the factors of production used to make them, then they are shipping a major share of the resulting output back to Russia on a barter basis to pay for the materials, leaving little if any real net gain for the people. Large volumes of food products are also exported both as part of barter agreements to pay for imported energy and materials and in response to price controls in the domestic market.

GDP has been further overstated by enterprises taking advantage of the National Bank attempt to restrain exchange rate fluctuations. The spread between the official and market rates for the Belarusian rouble was small in 1996 but jumped up to 10% in 1997. The spread means that enterprises can increase their profits by getting an intermediary to buy their products for Belarusian roubles, sell them in a foreign currency and convert the money back into Belarusian roubles. To legalise this process in their accounts at the official rate, enterprises overstate their quantitative output. Its no coincidence that economic growth in Belarus began in April 1996 after the spread between official and market exchange rates began to increase.

The gains in official GDP may therefore be as much an illusion as an accurate reflection of the economic circumstances of the Belarus people. Actual living standards continue to erode as the flight of food from Belarus to Russia through barter and smuggling leave the shelves bare for important products like cheese, butter, meat and eggs.

Without the threat of bankruptcy, enterprises have no incentive to voluntarily undertake the measures needed to become more efficient. The threat of losing ones job as a manager or ones assets as an owner fosters changes that bring efficiency and expenditure discipline. These changes may include selling off unused assets, finding new equity partners, voluntarily restructuring and privatizing, investing in new equipment and technology to improve production efficiency and product quality, or for seeking Out new markets.

The problems are exacerbated by a crumbling banking sector. The banking sector in Ukraine is already weak because most of the banks are either small start−up−banks with no previous experience and little capital, or they are large banks left over from the Soviet era that are struggling to restructure themselves and operate in a market economy. They are weakened further when they are forced to lend money to the Government and to public enterprises at artificially low interest rates. Their profitability is further hit by the high reserve requirements that the central bank introduces to reduce domestic liquidity and prop up the exchange rate.

Faced with low profitability, the hard−pressed commercial banks extend increasingly risky loans to failing enterprises at high interest rates to compensate. When enterprises fail to repay their loans on time, the banks face a serious liquidity crunch.

Under such conditions, providing liquidity support to avert a crisis would be inadvisable without restructuring. This would involve the merger or closure of under−capitalized banks or their acquisition by other investors, including foreign banks. However, this approach would not be consistent with the preservation strategy. As a result, the liquidity problems become a solvency crisis. More banks, their meagre assets eroded by bad loans, would close their doors. When the banking crisis becomes unavoidable, it will be quite destructive. By disrupting

the flow of payments, the crisis makes it impossible for otherwise good banks and creditors to make payments, thereby triggering widespread loan defaults. The economic decline would inevitably become worse after such a crisis, and restoring growth would become an even longer and more painful process.

Employment

The strategy has the advantage of maintaining official employment levels in the short term. But, by keeping them employed in unproductive industries, the Government is preventing workers from moving to those areas where they would add value.

The preservation strategy has the advantage of maintaining official employment levels in the short term. It avoids the laying off of large numbers of public sector employees and maintains employment opportunities within businesses that would be bankrupt if subsidies were withdrawn.

However, official employment levels would be deceptive. The growth of wage arrears suggests that many enterprises are unable to pay their employees. Under these circumstances, employment does not convey many benefits to the worker. If even subsidized enterprises are unable to pay their employees, the workers must not be making a significant contribution to the value of goods and services produced in Ukraine. By keeping

them employed in unproductive industries, the Government is preventing workers from moving to those areas where they would add value.

If the preservation strategy is harmful to economic growth, over the longer term it will limit the opportunities for new job creation. Achieving economic growth is the best way to generate new employment opportunities. In addition, if the strategy resulted in an overvalued exchange rate, it could also have harmful effects on employment. It creates a bias against employment. When imported capital equipment is made artificially cheap through an artificial exchange rate, producers will tend to substitute imported equipment for domestic workers or domestically produced equipment. An overvalued exchange rate also makes imported consumer goods artificially inexpensive, leading consumers to prefer imported goods over those which are domestically produced. This reduces the profits of domestic producers and thus their ability to pay taxes, to repay bank loans, to use domestic materials as inputs and to hire new workers.

Equity

The preservation strategy protects enterprises rather than people. Providing subsidies and tax exemptions to inefficient enterprises benefits only those who own and manage the enterprise.

On the positive side, the preservation strategy clearly has two advantages in terms of equity. These help explain why Ukraine has tended to follow this strategy during the past seven years. First, most people like stability and dislike change. Unless the current situation becomes intolerable, humans instinctively prefer the status quo. Second, change almost always brings a degree of civil and political unrest because it upsets the established order and the associated vested interests. By pursuing a strategy of very gradual change, Ukraine has protected vested interests and minimized political and civil unrest.

However, by protecting vested interests, the preservation strategy tends to underscore existing income inequalities in society. It generally favors a limited group of powerful individuals with a vested interest in the status quo. To preserve social peace, the government does not "rock the boat."

There is evidence of growing inequality of the income distribution in Ukraine. There are some particularly vulnerable groups in society. The most vulnerable group in Ukraine today is families with more than three

children—especially if the family is headed by a single parent (usually a woman). This group is about twice as likely to be poor as the average household. Pensioners are commonly regarded as being the most likely group to fall below the poverty line.

Therefore, the preservation strategy protects enterprises, rather than protecting people. Money that could be spent on protecting the most vulnerable in society is instead directed towards those that have political clout. Providing subsidies and tax exemptions to inefficient enterprises benefits only those who own and manage the enterprise. It does not benefit those workers who are not paid despite continuing employment and work. It does not benefit consumers who can not buy the goods and services that they want to as resources are channeled into unproductive enterprises. It

does not benefit the owners and employees of productive enterprises who are forced to pay high taxes to finance their unproductive counterparts.

Summary

The preservation strategy avoids some of the social costs involved in moving from a centrally planned to a market based economy. However, the strategy does not appear to be sustainable and only postpones the costs associated with the inevitable transition to a market economy. Overall, preservation will ultimately fail to promote the Government's objectives of economic growth and equity. Is there a better way? The following chapters explore two fundamentally different strategies for bringing about the economic changes needed to restore, preserve, and enhance the living standards of the people of Ukraine.

6—
Protection Strategy

External and internal forces interested in the uncontrolled import of certain products have actively blocked state regulations that could protect Ukrainian producers . . . The economic crisis can be overcome, but only by an economy founded on domestic production."
Ukrainian League of Consumers and Producers.

The protectionist strategy involves shielding selected domestic industries from competition with external and other domestic producers. Protection from external sources can take many forms including tariff and non−tariff barriers. Privileged domestic enterprises may be protected from domestic competition by fiscal, quasi−fiscal and regulatory instruments.

Advantages

The protection strategy often stimulates investment, including from foreign investors who want to "get behind the tariff wall." Old factories take on new life; new factories are built, and jobs are created. Tariffs and import duties can also generate revenue for the Government.

Disdvantages

A protectionist strategy make factors such as access to decision−makers and to special privileges more important to the financial success of an enterprise than production efficiency and effective marketing. As a result, protectionism tends to lead to economic inefficiencies, making goods and services more expensive for consumers. These inefficiencies ultimately undermine economic growth.

The Strategy

In the most conservative form, protection is limited to competition from selected imported products for a limited period of time. At the other extreme it may involve measures that virtually eliminate external competitors. On the domestic side, protection can be offered through subsidies, privileges, and preferential state procurement for selected domestic producers.

Protectionist strategies come in many different varieties. In the most conservative form, protection is limited to competition from selected imported products for a limited period of time. At the other extreme protection may involve prohibitive tariffs, quantitative restrictions, import bans, and quality certification procedures that virtually eliminate external competitors. On the domestic side, protection can be offered through subsidies, privileges, and preferential state procurement for selected domestic producers, often public sector enterprises, which have trouble competing with other domestic producers.

This chapter will not explore the many variants of the protection strategy, but will focus on the key instruments and tactics of protection that have been used or are being considered in Ukraine. It then examines their im−

plications for the government's fiscal accounts, inflation, the current account, economic growth employment and income distribution.

Protection from External Competition

The main approaches that Ukraine uses to protect domestic producers from external competition are: (1) tariff barriers, (2) export subsidies, (3) non−tariff barriers and subsidies, (4) implicit barriers and subsidies.

The main approaches that Ukraine uses to protect domestic producers from external competition are:

Tariff barriers. Specific and ad valorem duties are the most common instruments for protection against imports. In Ukraine, the weighted average duty is about 11% and about 5% under the "favorable scheme".2 The highest duties (up to 60%) apply to agricultural products. Seasonal tariffs may be imposed on these products, and these can roughly double the normal tariff rate, yielding maximum rates of up to 100% on vegetables, for example (Table 1).

Export subsidies can be used to protect domestic enterprises having trouble competing with foreign competition in external markets. Direct export subsidies appear to be very restricted in Ukraine.

Non−tariff barriers and subsidies. These instruments are increasingly being used in favor of Ukrainian producers. Explicit quantitative restrictions on imports are still limited in Ukraine—applying only to skins, live animals and meat, and they are intended to protect Ukrainian farmers whose productivity has fallen significantly behind world standards. However, there is considerable potential for immediate, widespread and ad−hoc application of quantitative restrictions. A Cabinet decision of June 26, 1996, allows import limits to be imposed whenever it is deemed necessary "to prevent or remove serious damage to national enterprises." The decision, which provides only loose guidelines for what qualifies as "serious damage", allows the restrictions to be put into place for up to eight years.

Implicit barriers and subsidies are perhaps more prevalent. Much of the trade in agricultural products, for example, is still controlled through state−owned or state−controlled, co−operatively owned agricultural enterprises. These enterprises have the power to favor domestic producers. As in many countries, quality certification procedures have the potential to be used to restrict competition from imported goods. Recent well−known cases in Ukraine include delayed or non−certification of television sets, car parts, detergents, and

toothpaste from internationally known producers.

Subsidies, which can be used to protect domestic producers both from foreign and domestic competition, will be discussed in the following section.

2 Michael Michaely. 1998. *Ukraine: Foreign Trade and Commercial Policies.* World Bank, processed., p. 8.

Table 1 Import duties for top ten product groups, %							
Product	Mln	Favorable rate			Full rate		
	$	min	avg	max	min	avg	max
Petroleum products	7,807	0	1	2	0	5	10
Non−electrical machinery	1,961	0	4	30	1	12	40
Transport except railway	639	0	9	20	20	21	40
Electrical machinery	634	0	6	25	2	15	40
Pharmaceutical products	424	10	10	10	20	20	20
Plastic goods	367	0	3	10	2	9	10
Rubber	358	1	5	5	5	10	20
Paper, carton	327	0	7	25	2	11	40
Other chemical products	264	0	3	10	5	9	10
Optical, photo, med equip	231	0	6	10	1	14	20
Notes. This table covers 76 percent of all products by value in 1997							
Source: Ministry of Finance of Ukraine and Bank staff estimate							

Protection from Internal Competition

Protection from more efficient domestic producers is also common in Ukraine. Protection for less−efficient producers comes through fiscal, quasi−fiscal and non−fiscal measures.

Although popular attention tends to be focused on the issue of protection from foreign competition, protection from more efficient domestic producers is also common in Ukraine. Protection for less−efficient producers comes through fiscal, quasi−fiscal and non−fiscal measures.

Fiscal Protection. Ukraine has made significant reductions in the use of fiscal measures to protect selected enterprises. In 1994 "Support to the National Economy" accounted for 13% of GDP, of which a major share went to support loss−making agricultural enterprises. By 1998 this had dropped to 2% of GDP. Similarly the use of directed credits from the budget to enterprises has declined sharply. In 1992 these amounted to 13% of GDP, but had fallen to zero by 1996. On the revenue side, the government provides substantial amounts of support worth an

estimated UAH 1.7 billion in the form of preferential or zero tax rates and by failing to take enterprises into bankruptcy court for the non−payment of taxes. In some cases, such as the elimination of value added taxes on meat and milk products in the agriculture sector, entire sub−sectors are given preferential tax treatment. In other cases, individual enterprises are given special tax and subsidy treatment. This is commonly done because the enterprise is in an area of "strategic importance" such as high technology, or because the government wants to avoid large−scale reductions in the number of workers employed. Such preferential protection has been given, for example, to the AvtoZaz−Daewoo plant in Zaporizhia both on the basis that the motor vehicle industry is a priority sector and to protect the 20,000 jobs in the plant (Box 2).

Box 2 Protecting the Automobile Industry

The Daewoo−AutoZAZ joint venture is the largest single foreign direct investment in the Ukrainian economy. To attract this investment the Ukrainian Government made a number of concessions designed to support the development of the "infant Ukrainian automobile industry". These concessions are available to any enterprise that is willing to invest at least $150 million in the automobile industry. They include:

A zero VAT and excise rate on the imports of manufacturing equipment, construction materials and car assembly components.

Exemption from land tax.

Exemption of reinvested profits from the enterprise's tax liability.

Exemption of cars assembled in Ukraine from VAT and excise duties.

Bans on the imports of cars over five years old.

Tariffs on imported cars.

In return for these concessions, Daewoo agreed that their workforce would be at least 90% Ukrainian. Around 20,000 Ukrainians are employed by Daewoo. However, these jobs have come at a high cost to the Ukrainian consumer and taxpayer. The imposition of tariffs increases the price Ukrainians must pay for a new or used car; the import of cars over five years old, which are very popular in Ukraine, is banned; minimum value of USD 5,000 is imposed in calculating import duties to be paid; and tax exemptions implicitly increase the tax burden borne by other Ukrainian enterprises and workers. The cost to consumers varies depending on what foreign investment Ukraine would get in the absence of these concessions. However, a World Bank estimate suggests that, when operating at planned capacity, the cost of protecting each job in the Daewoo plant could run into several thousand US dollars per month. This compares to an average wage in Ukraine of USD71.3 per month for 1998.

To date, local manufacturing has been limited to "screwdriver technology". In order to gain access to the highly concessional tax treatment on imported parts as opposed to finished cars, the company is exporting the full−assembled cars from Korea to a neighboring country, removing the wheels and seats there, then replacing the wheels and seats once the vehicles arrive in Ukraine.

The venture has also not been as successful at boosting production as hoped. In 1998, only 24,000 motor vehicles were produced, significantly lower than the 70,000 planned. Furthermore, the company is having trouble finding a market even for these cars leaving roughly half of production unsold. Production was suspended due to low sales in late 1998 and, in mid−1999 had not yet restarted normal production.

Quasi−fiscal measures. Protection through quasi−fiscal and non−fiscal measures is still common in Ukraine. Government−directed commercial bank loans at special rates, usually to enterprises that would not qualify for loans under normal commercial criteria, are perhaps the most important form of protection. Lax enforcement of loan repayment is another implicit subsidy. Of the outstanding budgetary loans to enterprises in Ukraine, a significant share is overdue, and of these, many will almost certainly never be repaid in full. Loan guarantees are another instrument that can be used to protect favored enterprises. The Government has guaranteed an estimated USD 2.5 billion of foreign currency loans for enterprises.

Almost all of these enterprises are in the public sector or have close political ties. Of these, the Government has already had to repay loans totaling USD 1.4 billion, equivalent to about 90% of the total guaranteed loans maturing. Against this amount, it has managed to recover around USD 900 million (65%) repayments in−kind and in local currency. In other words, the effective default rate is very high, reflecting a substantial implicit subsidy to these enterprises.

Non−fiscal measures. Complex controls and regulations also provide the Government with a tool to protect favored enterprises. Favored enterprises can be protected by making it easier for them to operate relative to their competitors.

Evaluating the Protection Strategy

In this section we evaluate the probable consequences of the protectionist strategy in terms of the indicators identified in chapter 2. These are the consequences for the fiscal situation, inflation, the current account, economic growth, employment and distribution of income.

Identifying the probable impacts of the protection strategy with precision is difficult because the effects can vary greatly depending on the nature of the instruments used, the degree to which the policies provide protection from foreign competition or from competition with other domestic enterprises, and the intensity with which these instruments are used. However, we attempt to highlight the key benefits and costs of a protection strategy.

Fiscal Position

The biggest fiscal advantage of a protection strategy is that, if well administered, it can generate substantial import tax revenues. However, subsidies and tax concessions create budgetary pressures that increase the budget deficit.

The biggest fiscal advantage of a protection strategy is that, if well administered, it can generate substantial import tax revenues. In fact, underdeveloped countries depend on import duties for a much larger share of their total tax revenues than in developed countries. In the short term, the stimulation of investment and output can also boost overall tax revenues.

Although import duties can help the budget, they can also have serious drawbacks. In particular, unless the customs service is well administered and reasonably free from corruption, a major share of the potential revenues is likely to go into the pockets of the customs agents. Hard data is not available, but professionally conducted surveys indicate that the people of Ukraine regard the customs service as one of the most corrupt institutions in

the country3 .

In addition, some aspects of a protection strategy can create negative fiscal consequences. Subsidies and tax concessions create budgetary pres−

3 The *TI Newsletter* of December 1998, for example, reports on the basis of six different surveys that, between Denmark at 1 and Cameroon at 85, Ukraine ranks 69 along with Bolivia. Its 1998 integrity score was 2.8 out of a possible 10 points.

sures that increase the budget deficit. They also create a precedent: new enterprises, both domestic and foreign, will insist on the same tariff protection and tax give−away packages that previous enterprises enjoyed. It is difficult for a government to resist these pressures without going back on the promises made to all producers. This type of policy turn−around would risk the exit of enterprises to locations where policies are more stable and predictable. These problems have been seen clearly in Ukraine in the case of concessions for foreign direct investment during the past few years. Some concessions became so costly that the government was forced to renege on its promises in 1996/97.

The pressures for more fiscal concessions will also come from those who are already protected. The favored enterprise managers quickly learn that there are high returns from lobbying and bribing the government to provide more support. They will therefore divert their attention from managing the enterprise and marketing their output to campaigning for additional government support.

In fact, one of the risks of a protection−focused strategy is that it encourages corruption, not only at the border, but throughout the economy. Discretionary elements in both protection and subsidies create opportunities for corruption that drain resources from the budget and bias investments in favor of those with political connections and the will to pay bribes. This undermines the overall investment climate by making it more costly and risky to do business.

One of the reasons to offer concessions to new industry is to build a larger tax base, thereby improving the nation's fiscal position. However, the concessions give away the tax base before it is even created, and clever enterprises around the world figure out ways to create "new" companies and take advantage of new rounds of tax holidays and other fiscal concessions just at the time the Government is set to begin enjoying a larger tax base. The enterprises that do not win new rounds of concessions may pack up and leave. This is a particular problem in the case of "footloose industries" that, having few investments in non−movable capital equipment, can easily move to other countries offering larger tax exemptions. This includes a major share of the textile, footwear, garment, and high−tech industries, all of which could be very important to Ukraine's development in the coming years. Therefore, tax concessions may actually undermine the business climate, resulting in lower growth as well as more serious fiscal problems.

A protectionist strategy will not necessarily lead to fiscal problems. A government could fund subsidies and tax concessions by cutting expenditures in other areas. But reducing subsidies and tax concessions would free government resources to spend on those things, which the private sector is often poorly equipped to handle. These include the provision of general public services, public safety, public health, a major share of the education facilities, contract enforcement and maintaining public law and order.

Inflation

If the protectionist strategy does lead to fiscal deficits, the consequences will depend upon the way government finances these deficits.

If the protectionist strategy does lead to fiscal deficits, the consequences will depend upon the way government finances these deficits. As under the preservation strategy, the risk for inflation arises if deficits are funded via borrowing from the central bank. This would contribute to inflationary instability that endangers both the banking system and the economy at large. The instability of the environment that is created, plus the increasing inefficiency of the protected enterprises, creates problems for customers to repay their bank loans, adding to the risk of a banking crisis.

However, if the government manages to maintain fiscal discipline, the protectionist strategy will not have negative consequences for inflation or the banking sector. Any increases in tariffs will increase consumer prices but, if tariff rates are stable over time, protection will not make an ongoing contribution to inflation.

However, there can be risks to the banking system if governments try to protect enterprises by pressing banks to make loans to failing enterprises, thus weakening their portfolios. There is a significant risk of a banking crisis when lending decisions are not based on a competitive, commercial, arms−length process. This was one of the main contributors to the severity of the Asian crisis starting in the fall of 1997.

Current Account

The consequences of a protection strategy for the current account also depends heavily on the way in which the strategy is implemented. If only modest levels of import duties are involved that apply equally to all products, and if the level of protection is stable or falls over time, the initial impact on the current account may be positive. Import duties will discourage imports, thus reducing the trade deficit, at least in the short term.

If a more aggressive and selective protection strategy is pursued, it can result in serious trade and payment problems almost from the outset.

If a more aggressive and selective protection strategy is pursued, it can result in serious trade and payment problems almost from the outset. One common mistake is to impose high duties on finished goods and low duties on intermediate inputs and capital equipment. This approach is designed to stimulate local production by making inputs cheap and protecting the finished goods from competition. Local production will be stimulated, but only at high cost, and the tariff protection may actually make the trade balance worse.

Why? Enterprises, often in co−operation with foreign investors, import large volumes of capital goods to establish domestic production facilities behind the tariff walls. They also import large volumes of intermediate inputs to make the finished products. The Daewoo−AvtoZaz project noted above is an example of this problem. Since the domestic scale of production is normally far below world levels, the domestic production does not enjoy full economies of scale, and consequently uses more inputs to produce the same output, wasting resources and slowing economic growth. This is a particular problem with capital equipment, which tends to be

under−utilized because it is designed for world−class levels of production and is not available in smaller sizes. When the cost of the inputs exceeds the value of the output at world prices, the country may actually end up spending more foreign exchange for the product than if the product were imported directly.

Even if the protection strategy succeeds in discouraging imports, there can be negative impacts on the trade balance from the impact of protection on the exchange rate. If high tariffs discourage imports, they will reduce the demand for foreign exchange. The upward pressure on the exchange rate makes exports less profitable and their volume declines.

The bias against exports that is created by protectionist policies can be corrected if the government introduces export subsidies and multiple exchange rate policies, but this quickly leads to even greater problems:

The government is put into the position of having to "pick the winners" entitled to receive the export subsidies.

If the government tries to avoid having to decide who gets the subsidy, everyone gets them, and this quickly causes a fiscal crisis.

Since the export subsidies are very valuable, enterprise managers will be willing to pay large bribes to get them, creating an environment of corruption. The associated risks seriously impair the attractiveness of a country as a location for investment.

Economic Growth

The primary objective of the strategy is to encourage domestic production. Measured by this criterion, the protection strategy is usually successful initially. Unfortunately, production will not mean growth if goods are produced in ways that waste valuable human, capital and material resources.

The primary objective of a protection strategy is to encourage domestic production. Measured by this criterion, the protection strategy is usually successful initially. Experience with protection strategies around the world is that such strategies do initially stimulate production and would probably succeed in Ukraine for at least a few years. Protection can and does stimulate investment in the short term. Investment creates new jobs. And new jobs generally raise living standards (though these gains can easily be offset by the higher costs of consumer goods due to inefficient domestic production and import duties).

Unfortunately, increasing production does not always translate into economic growth. Production will not mean growth if goods are produced in ways that waste valuable human, capital and material resources. Protectionist measures, which are commonly applied on a discretionary basis, make factors such as access to decision−makers and special privileges more important to the financial success of an enterprise than production efficiency and effective marketing. Good relations with the power elite become the primary concern of managers because this can provide protection from competition. Lack of competition leads to falling production efficiency and falling product quality, necessitating even more protection that becomes more and more costly to provide (Box 3).

The success of a protectionist strategy ultimately depends on the ability of government to "pick winners". If a government is going to pass out favours to protect specific enterprises, it has to decide which enterprises are worth protecting. Problems arise even in the absence of corruption. Serious government officials often try hard, as under GosPlan, to identify the enterprises with the greatest potential for contributing to GDP and higher living standards. However, the experience of the Soviet system, as well as that of protection−focused countries around the world, illustrates that it is almost impossible for a government official to know enough about alternative lines of economic activity which have the best potential for long−term growth. In particular, it seems unlikely that the government is better able to identify winners than economic agents who are willing to invest their own money in a particular enterprise. However, an argument can be made for a limited amount of protection for a relatively fixed time period in the event of "market failures" which prevent enterprises and industries from realizing their potential efficiency and competitiveness. The terms and conditions under which modest protection may be justified as a transitional measure are developed in the followed chapter.

Box 3 International Experience with Protectionism

Many countries around the world have dabbled in protectionism to a greater or lesser extent.

Protection in its extreme form was seen in the Latin American region in the 1960s and 1970s. The results were very bad in terms of efficiency and economic growth, and most countries in the region have now moved to a competitiveness strategy. Protection of a considerably less extreme form was common until recently in the East Asia region. Here the more modest levels of government intervention and protection from imports produced very good results: the much−discussed "East Asian Miracle." But as the recent Asian crisis has clearly shown, the system had profound weaknesses. In particular, because of the tight relationships between banks and enterprises through the "keiretsu" system, capital was not allocated on a competitive basis. This, coupled with the lack of adequate government supervision on the quality of bank lending, create a debt−heavy, fragile financial structure, making the enterprises highly vulnerable when economic conditions became difficult. (In 1996, corporate debt averaged 200 percent of equity in Indonesia, 240 percent in Thailand, and 350 percent in the Republic of Korea (Kawai, M. 1999. A Comparative Study of Financial and Corporate Restructuring in east Asia. Washington, DC: World Bank). When the pyramid of debt began to disintegrate, the collapse in living standards was profound.

The artificially propelled ride driven by protectionism and crony capitalism can be exhilarating as long as it lasts. But in the end, the lack of competition leads to falling production efficiency and product quality, necessitating even more protection that be−comes more and more costly to provide. The protection may come through higher tariff levels as in the case of Latin America, or it may come through privileged access to bank loans as in the case of the East Asian countries. Ultimately, the system will collapse because of its intrinsic inefficiency.

The evidence from countries around the world indicates that restructuring a protected economy will ultimately be inevitable and unavoidable. Cases can be cited from countries on every continent in the world. Examples can even be drawn from the experience of countries that are otherwise successful and competitive but which, for political reasons, have chosen to protect certain sectors. These include the coal industry in Britain, the textile and steel industries in the United States, the rural sector in France, the banking industry in Japan, and the industrial sector in Korea.

While the protectionist strategy may appear to work in the short term, the negative consequences of the strategy would emerge over time. As the number of protected enterprises increased, and as the degree of protection that they required to keep operating increased, consumers would face decreases in their real incomes, as they would increasingly have to pay more for less. High costs of production would translate into high product prices and low quality of goods and services.

Unfortunately, removing existing protectionism can be costly. Once investments have been made in protected industries, for example, it can take a long time and a lot of money to convert these into enterprises that are competitive on world markets. If access to international capital markets has become difficult, the country must divert scarce domestic resources from consumption to investment. The consequent decline in living standards always makes adjustment programs painful and unpopular. However, the IMF and World Bank will come to the assistance of countries like Ukraine if they wish to move away from a protectionist strategy. These organizations can reduce the extent to which the people of the country must sacrifice consumption in order to undertake the investments required to help the country restore growth.

Employment

The protectionist strategy can be successful at protecting jobs in the short term. But by delaying workers' move to more profitable enterprises, it will reduce labor productivity and the ability of workers to earn higher wages.

The protectionist strategy can be successful at protecting jobs, at least in the short term. Without protection some enterprises may collapse leading to job losses and growing unemployment.

However, limits to protection will eventually be reached and enterprises will begin to lose money. As a consequence wage arrears would build, new job opportunities would decline and unemployment would increase. Basically the government will not be able to protect jobs in inefficient industries forever. A protectionist strategy may simply delay the costs to workers in inefficient enterprises.

The strategy may even increase costs to workers. By delaying their move to more profitable enterprises, it will reduce labor productivity and the ability of workers to earn higher wages. Over the longer term, by hindering the development of new productive enterprises, a protectionist strategy is likely to limit new job opportunities.

Distribution of Income

The protectionist strategy is often defended on equity grounds. But, while diffuse, the costs to consumers are usually greater than the benefits to protected plants and workers

The protectionist strategy is often defended on equity grounds. In particular, if a country already has protected enterprises or industries, opening them up to competition may result in bankruptcy. This can impose high costs on the owners, managers and workers of those enterprises.

The removal of protection is often strongly opposed politically because the benefits to protection are concentrated with one or a few producers, while the costs are diffused or widely spread. The costs are faced by the thousands or millions of consumers who must pay higher prices for goods

and services and by taxpayers who fund the payment of subsidies and tax concessions. Protection represents a transfer from consumers and nonprotected enterprises to protected enterprises. As a result, the costs are often paid by the most vulnerable in society such as pensioners who must pay more for goods and services produced by protected industries.

While diffuse, the costs to consumers are usually greater than the benefits to protected plants and workers. Overall it will probably be less costly to protect these workers via unemployment benefits and training programs that help them find new employment.

Summary

There are both winners and losers from a protectionist strategy. Following this strategy does help to maintain production and employment levels for at least a short period. If government is successful at "picking winners", limited protectionism may help develop new industries and deliver economic growth over longer periods. However, the information constraints on policy makers creates a significant risk that resources will be channeled into inefficient industries (see box on international experience). The strategy will not add to the productive capacity of the economy if resources are directed towards those industries that are not efficiency at turning inputs into the goods and services demanded on domestic and foreign markets.

7—
Competitiveness Strategy

". . . only competitive producers can hope for successful trade. Therefore increased competitiveness has to be one of the priorities of the industrial policies in Ukraine . . ."
—A. Vrublevsky, G. Tryneyev and M. Yakubovsky

A competitiveness strategy implies a much smaller role for Government than the preservation or protectionist strategies. Under this approach, the Government focuses, not on subsidies that preserve the past or picking "winners" and protecting them, but on creating an environment that encourages competition and gives all producers an equal chance to succeed.

Advantages

Under the competitiveness strategy, resources will be directed towards producing those goods and services that Ukraine is best at. This reduces the costs of goods and services to Ukrainian consumers and enhances Ukraine's prospects in export markets, and maximizes economic growth, employment and living standards.

Disadvantages

The most significant cost of adopting this strategy would be faced by those workers in falling enterprises that are unable to stay afloat in the new competitive environment. While new jobs would be created in more productive industries, these workers may lack the skills to benefit from the new employment opportunities. Therefore, the government may find it necessary finance unemployment benefits and retraining schemes during the transition period.

The Strategy

The tactical measures required under the competitiveness strategy are actually much simpler for a government to implement than those required under either the status quo preservation strategy or the protection strategies.

In broad−brush terms, government simply needs to create an environment that encourages competition and facilitates business activity. Competition will lead to efficient production by ensuring that goods and services are produced by those who can produce them at least cost. Uninhibited price signals will also tell producers what goods and services consumers want to buy.

A competitiveness strategy implies that all producers have an equal chance to succeed. In other words, a government that chose to follow a competitiveness strategy would not give individual enterprises or industries preferential treatment in terms of subsidies or protection from competition.

Evaluation of the Competitiveness Strategy

This section evaluates the competitiveness strategy in terms of its impact on the fiscal situation, inflation, the current account, economic growth, employment and equity.

Fiscal Position

The competitiveness strategy may put upward pressure on the government deficit in the short term. However, closing such enterprises, or selling them to private investors who will restructure them into modern, efficient

enterprises, could save the Government a lot of money. Protecting workers is almost always far cheaper than protecting production.

Under the competitiveness strategy the Government plays no direct role in supporting enterprises other than providing economic and legal infrastructure. However, Government still has some role to play in allocating resources even under a competitiveness strategy. In some situations markets fail to allocate resources efficiently. Even governments that generally follow a competitiveness strategy intervene in this and other circumstances where markets may not produce the best outcome. Sometimes this intervention is to promote economic growth and sometimes it is for equity reasons. The extent and type of government intervention varies across countries. It depends on the extent to which governments believe they have the ability to improve the situation and social beliefs about the role of government in redistributing income.

The size of government can vary greatly among countries pursuing competitiveness strategies. However, under the competitiveness strategy any government intervention should follow a strict test. Policy makers should be sure that the social benefits of intervention outweigh the costs. In addition, when pursuing equity objectives, governments should ensure they choose the most efficient way of achieving those objectives.

The competitiveness strategy may put upward pressure on the government deficit in the short term. Under a competitiveness strategy, revenue gained from import duties and tariffs would be limited. It will also not be cheap to put in place the institutions that are needed to assure a level playing field for all producers. Significant investments in legislative foundations, regulations, training, libraries, electronic communications and salaries will be needed to establish the well−functioning court and arbitration systems that are needed to enforce the rules of the game equitably for all competitors. And money will be needed to create a tax system (including customs) that spreads the tax burden as widely as possible and makes liabilities under the tax laws transparent, predictable and equitable.

Based on the experience in other countries, however, the total cost of the investments in these areas would be only a few percent of GDP. This

could be financed initially with the help of organizations such as the World Bank, then out of the savings and improved economic activity that such investments would yield.

The competitiveness strategy would also require increases in social spending in the short term to protect the most vulnerable from the costs of transition. Failing old state enterprises in the agricultural and industrial sectors provide a *de facto* social safety net for roughly 8.5 million Ukrainians who work there. Many of these enterprises are too inefficient to compete on a level playing field and will have to be restructured dramatically or closed if a competitiveness strategy is implemented. To minimize the social costs from these changes government will need to provide assistance in the form of unemployment benefits, retraining and job search assistance.

However, closing such enterprises, or selling them to private investors who will restructure them into modern, efficient enterprises, could save the Government a lot of money. A positive resource flow should also be generated by privatization proceeds.

The fiscal gain from these sources is likely to exceed the costs of the safety net needed to protect workers. Protecting workers is almost always far cheaper than protecting production, especially if the production is value subtracting. Furthermore, good economic policies that encourage the creation of new jobs can greatly reduce the money that will have to be spent on income support payments to workers who have lost their jobs. Good tax policies would allow the Government to capture enough of savings in reduced enterprise subsidies and tax privileges, and enough of the new economic growth, to provide the necessary support to disenfranchised workers.

Unfortunately, while the fiscal costs of adopting the competitiveness strategy may be more immediately apparent, many of these benefits will take time to materialize. On the other hand, most transitional costs could be financed with foreign assistance. Institutions such as the IMF and World Bank support the competitiveness strategy around the world, and if Ukraine were to adopt it wholeheartedly, the necessary assistance would be forthcoming.

Inflation

The strategy is likely to have positive implications for inflation. If donors finance any short−term fiscal pressures, there will be less pressure on the government to print money. In the longer term, reduced subsidies and growing tax revenues will bring the budget closer to balance.

The competitiveness strategy is likely to have positive implications for inflation. If international organizations finance any short−term fiscal pressures, there will be less pressure on the government to print money. In the longer term, reduced subsidies and growing tax revenues will bring the budget closer to balance. Firmer fiscal policy will assist the National Bank of Ukraine in its efforts to control inflation.

Reduced inflationary pressures would make it possible to maintain a stable exchange rate and growing net international reserves without capital

or exchange rate controls. This strategy would facilitate establishing stable exchange rate and the more stable economic environment would reduce the risk of investors fleeing Ukraine. This approach is far more effective than artificial controls designed to restrict the demand for foreign exchange and increase its supply.

Current Account

In the short run, eliminating controls on foreign exchange would almost inevitably cause a further devaluation of the exchange rate. However, this may be desirable. Trying to maintain the currency at an artificially high level undermines the competitiveness of Ukraine's exports and import competing firms. Furthermore, the resulting devaluation may be modest. With the recent devaluation of the hryvnia, the real exchange rate is now near its level in late 1995 (Figure 8). In this period foreign exchange reserves were relatively stable and net sales of foreign exchange by the National Bank of Ukraine were modest.

The reduction of import controls is likely to increase imports into Ukraine. With low inflation and a competitive exchange rate, exporters would find it easier to pros−per in foreign markets. This may ultimately offset the impact of any increase in imports on the trade balance.

The reduction or removal of import controls is likely to increase imports into Ukraine. In particular, we are likely to see an increase in the imports of capital equipment into Ukraine. While this may initially hurt domestic industries that compete with imports, they will be forced to become more efficient or switch to the production of goods and services in which Ukraine has a comparative advantage. The welfare of Ukrainian house−holds will be enhanced through access to cheaper imports and domestic goods and services.

Ultimately, the incomes of all Ukrainians will be boosted by using resources to produce the goods and services that Ukraine is best at producing. This will generate revenues that can be used to purchase imports of things that other countries can produce for less. For example, imagine you are an owner of a construction firm. Would you produce your own nails if you could buy them at a lower cost from another firm? It maximizes your profits to buy the nails from another firm and spend your time doing what you are best at. It is the same for the country as a whole.

With low inflation and a relatively stable, competitive exchange rate, exporters would find it easier to prosper in foreign markets. This may ultimately offset the impact of any increase in imports on the trade balance. Indeed given Ukraine's rich resources and central location, it has great potential for export success.

Ukraine would probably see an initial increase in its current account deficit under the competitiveness strategy. But, under these circumstances, this may actually be a desirable outcome. Remember that the current account deficit is the difference between national investment and saving. If the competitiveness strategy is successful at creating an attractive investment climate, we will see an increase in foreign investment in Ukraine. An increase in foreign investment, by definition, implies a widening gap between national savings and investment.

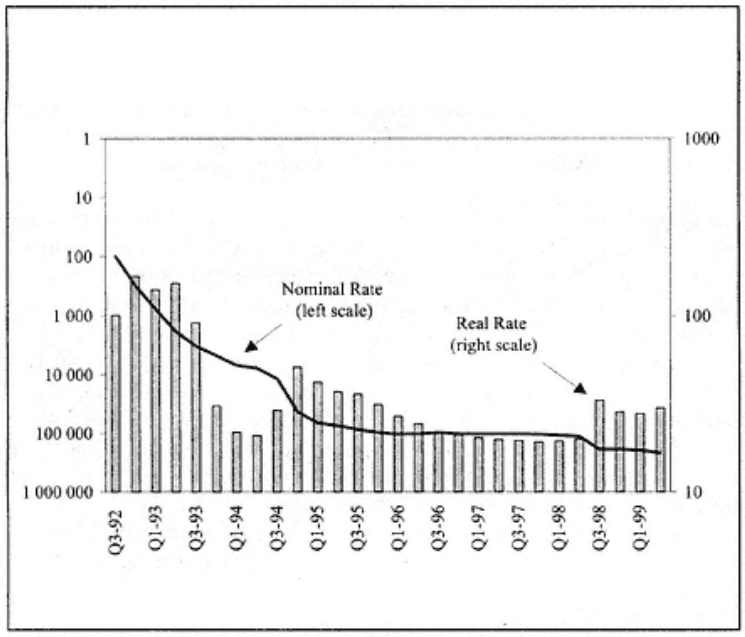

Figure 8
Nominal and Real Exchange Rate Indexes, 1992 Q3=100
Source: National Bank of Ukraine and World Bank

But in this case, in contrast to the preservation strategy, the deficit would be driven by investment not consumption. This type of deficit is desirable, indicating that Ukraine wants to benefit from foreign direct investment and has established an environment that attracts foreign savings and investment.

Economic Growth

The competitiveness strategy would be beneficial for economic growth. With no government bail−outs, low inflation, realistic and stable prices, and a stable exchange rate, enterprises would maximize efficiency. Creating a competitive, financially strong enterprise sector is one of the best possible ways to attract foreign investors.

The analysis above suggests that the competitiveness strategy would be beneficial for economic growth. With no government bailouts, low inflation, realistic and stable prices, and a stable exchange rate, enterprises would maximize efficiency by maximizing profits. Those who could not make a profit would restructure or close. Hard budget constraints on enterprises—the requirement that every enterprise must pay for what it uses out of what it earns—would be enforced with the threat of bankruptcy.

Bankruptcy has a negative connotation within the public at large. But bankruptcy is not death; it is rebirth. When an enterprise is bankrupt, with more debts than assets, using its labor and capital equipment efficiently is almost impossible because of the lack of working capital. Every dollar that is earned is subject to confiscation by creditors, including the government for taxes, the banking system for loans, other enterprises for materials and, under some circumstances, workers for wages.

In Ukraine the problem of staying in operation, which is necessary to provide any hope of repaying loans, is made particularly difficult by *kartoteka 2* (card−file 2), a system that allows the government to confis−

cate funds from enterprise bank accounts without their permission. A court order is not needed for the Government to put an enterprise into this file, leaving the enterprise in a very perilous situation. Once in the card−file, the enterprise has no way to assure that highest priority creditors are paid first. *Kartoteka 2* is a powerful incentive for enterprises to hide in the shadows, avoiding both the banking system and the tax authorities.

In contrast, Western−style bankruptcy proceedings allow the workers and physical assets of an enterprise to being working again. Some enterprises, of course, are bankrupt because their equipment is too worn−out and out−of−date to produce competitive products. Liquidation for such firms is almost inevitable. However, even here, the real estate owned by the firm may be of high value, attracting a new investor into the old location. This investor may possibly employ some of the workers from the liquidated enterprise. Under some bankruptcy proceedings, the new owners will assume part of the debt of the old enterprise in payment for the physical and other assets received during the restructuring process. Thus, bankruptcy does not automatically get rid of all the debts, but it reduces them to a level that will allow the new enterprise to resume operations. This provides renewed opportunities for increased employment and output. Bankruptcies would mean the write−off of many of the current outstanding loans from the banking system. However, in reality, the real change for the banks would be minimal. Many of the loans for non−competitive enterprises are already non−performing. And the better−run banks have already implicitly marked down the value of non−performing loans in their books by provisioning. Thus, a competitiveness strategy would simply reveal the reality that is already well known to the banks—a lot of their loans are bad and are never going to be repaid.

Banking losses would arise in the case of enterprises that are currently able to pay their loans only because of government subsidies and tax privileges. This support would be cut off under a competitiveness strategy and could force some loans into non−accrual status. However, a major share of such loans appears to be to agriculture, and most of these appear to have been extended by Bank Ukraine. If this bank were to be re−nationalized, as has been discussed on occasion, the Government would bear the burden of the restructuring. In such a situation, a major share of the decapitalization costs could be covered by savings from reduced subsidies and tax concessions and by increased economic activity and a wider tax base.

By removing any special support from the National Bank or the Government of Ukraine, a competitiveness strategy would force commercial banks to lend only to borrowers who were profitable and could repay the loans. Directed credit and most confessional lending would come to an end. On balance this would greatly increase the strength of the banking system, making it better able to serve the needs of a growing, competitive economy. In the process, some enterprises would have to restructure, seeking new equity investment partners, new products and new markets.

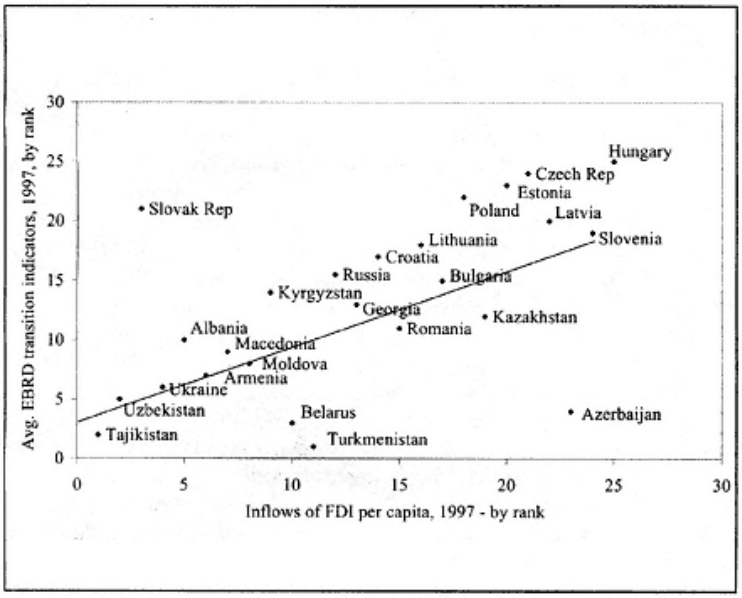

Figure 9
FDI and Reforms
Source: EBRD, Transition report 1998:

A competitiveness strategy would almost certainly lead to the merger or closure of various banks. Those that were simply too small to compete and to meet the capitalization requirements but were otherwise well−run would merge, forming banks that were strong enough to be successful in a competitive environment. The negative net worth of the worst run banks would be revealed by the competitive pressures and those banks would be forced to suspend operations. The bankrupt banks would sell their remaining assets to new investors, thus reducing the cost of bankruptcy both to the original investors and to the depositors.

Such closures and restructurings would have positive effects almost immediately. This process would prevent bad banks from continuing to work, taking people's money and using it to cover their losses—something that has happened too often in other countries, creating the risk of a serious systemic banking failure. A competitiveness strategy would help clean up the banking system and restore it to health, placing it in position to support growth and improved living standards.

The competitiveness strategy would also create a virtuous cycle within enterprises. Competitive pressures would lead to more efficient production and boost profitability. This would provide resources that the enterprises could use for reinvestment to further improve their efficiency, output, and levels of employment. The consequent expansion of production levels would allow enterprises to achieve greater economies of scale, increasing their ability to export. The improved economic conditions would attract additional foreign direct investment, further stimulating the growth process (Figure 9).

Box 4 The Polish Therapy

Poland is an example of a country that has chosen the competitiveness strategy. Over 1990 and 1991 Poland opened up its economy to foreign competition, liberalized prices, restructured enterprises, and rapidly privatized a number of small and medium sized businesses. The so−called

"Balcerowicz−Sachs" shock therapy initially hit the Polish economy hard. The therapy brought Poland two−digit unemployment rates and sharp declines in gross domestic product (GDP) and industrial output. By 1992 GDP was almost 18% lower than it was before the reforms in 1989. However, the Polish economy returned to growth in 1993 and by the end of 1996 had more than made up the ground lost during the early 1990s. By the end of 1998 economic activity is estimated to be 17% higher than in 1989. The transition has hit some groups in Poland hard. In particular, the transition to market prices has been reflected in significant falls in agricultural prices and farmers' incomes. Workers also saw large falls in the purchasing power of their wages. Inflation−adjusted wages have been increasing since 1993 but, due to large falls in the early 1990s, are still lower than in 1989. However, this largely reflects high inflation in the early 1990s as artificially low prices increased to market rates. This fall in purchasing power is deceptive. While in theory real incomes of workers were higher in 1989, in reality shortages meant that it was often not possible to exchange that income for goods and services. The recent crisis in Russia has curbed prospects for economic growth over 1999. Falling demand for Polish exports has taken some steam out of economic growth and will put upward pressure on Poland's current account deficit. However, Poland has found itself in a relativity strong position to cope with this crisis. Foreign confidence in Poland has been reflected in continued growth in foreign direct investment and protected the zloty from speculative pressure. The secure zloty has allowed Poland's monetary council to cut interest rates in response to the slowing economy and weakening inflation. Lower interest rates should help stimulate domestic demand and help prop up growth rates towards the end of 1999. Poland can not emerge unscathed from a slowing world economy. But it is no coincidence that former soviet union countries which have moved towards a competitiveness strategy, like Poland and the Baltic States, have been hit less hard than those who continue to implement a mixture of the preservation and protectionist strategies.

Creating a competitive, financially strong enterprise sector is one of the best possible ways to attract foreign investors. Experience around the world suggests that the competitiveness strategy is more successful—and far less risky for the government—than offering tax give−aways and other concessions (Box 4).

Investment from abroad is an important way for a transition country to grow. Even though some of the benefits from the investment flow back to the foreign owners, this investment does increase the economy's stock of capital, leading to higher productivity and higher wages. It is also a way

to learn the state−of−the−art technologies developed and used in richer countries.

Employment

Some workers are likely to lose their jobs under a competitiveness strategy. But many workers in Ukraine are already without income from their "jobs". In the longer term, if the government creates a good business climate, renewed growth will generate new employment opportunities.

Some workers are likely to lose their jobs and their incomes for extended periods under a competitiveness strategy. But even this may not be as serious as might be imagined. Many workers in Ukraine are already without

income from their "jobs" because their enterprises have not been able to pay wages for months. In fact, their incomes may actually rise. Freed of the obligation to show up every day to do work for which they never get paid, they become free to find other useful employment. Even if this time were only used to grow food for subsistence and small trading, the worker may come out ahead even in the short term.

In the longer term, if the government creates a good business and investment climate, renewed economic growth will generate new employment opportunities for most able−bodied workers.

However, one issue that the government would have to face in the transition to a competitiveness strategy is skills mismatch. While renewed economic growth will eventually create new jobs, many workers may lack the skills needed to work in the new environment. Ukraine may find itself left with a relatively high unemployment rate even after several years of solid economic growth.

Dealing with this problem by continuing to subsidize inefficient industries is very costly and perpetuates the problem. Perhaps the best approach the government can take is to invest in training strategies to equip workers with the skills demanded by Ukraine's productive enterprises. At the least, the Government needs to ensure that it provides adequate income support and job placement services to the unemployed.

Distribution of Income

There will be equity implications from the competitiveness strategy. The changes would create losers as well as winners. However, the increased investment, efficiency and output that would come with a competitiveness strategy would lead to higher incomes and standards of living for Ukrainian people.

The previous discussion highlights that there will be equity implications from the competitiveness strategy. The changes would create losers as well as winners. Some banks and enterprises would have to go through restructuring and possible liquidation, and this will hurt those who lose their jobs because of the restructuring or closure. However, as noted above, the real reduction of income in these cases may be relatively modest because of the widespread non−payment of wages in such enterprises. Some may also be successful in finding new job opportunities in the more competitive environment.

More generally, the increased investment, efficiency and output that would come with a competitiveness strategy would lead to higher incomes and standards of living for Ukrainian people. While not all people will succeed in the new environment, benefits are likely to be more broadly spread than under a preservation or protectionist strategy. Under

these two strategies, vested interests tend to secure a large share of the shrinking wealth of the country.

For those who are not be able to benefit in the short run from the transition process, the Government would need to provide a good social safety net. It could also reduce the social transition costs by providing support for small enterprise development, education and training to improve employment prospects and improved health care facilities.

The real standard of living of all people, including those temporarily without jobs, could be further enhanced by providing improved municipal infrastructure, especially in poor neighborhoods of cities and in rural areas, including clean water, access to sanitation, clean markets, reliable electricity supplies, public telephones, and more reliable public transport.

This type of government support would put upward pressure on expenditure. But it could be at least partly offset by the reduced cost of subsidies and tax exemptions. International organizations are also likely to be willing to

help bear these transition costs. If the municipalities, ideally with incremental financial help from the national government, were to step in and provide access to social services, the workers' real incomes may change very little with the closing of bankrupt enterprises.

Summary

The competitiveness strategy is not without its costs. Exposing inefficient enterprises to competition will have immediate negative implications for production levels and employment. As such, the costs of the strategy would fall most heavily on those individuals who lost their jobs and this is a key reason why Ukrainian decision−makers have been slow to adopt elements of this strategy. However, the benefits of the competitiveness strategy appear to outweigh the costs. Competitive pressures will force the efficient use of Ukraine's resources, the key determinant of future living standards. This suggests that there are more effective ways of protecting the incomes of workers than subsidizing their employers.

8—
The Transition to a Competitive Economy

"A combination of industrial and foreign economic policies has created radically new fundamentals for Ukraine's economic rebirth based on higher efficiency and competitiveness."
—A. Vrublevsky, G. Tryneyev and M. Yakubovsky

In a well−functioning market economy with a strong financial sector, sound economic policies, and a market−oriented government, the transition costs—even for "infant" and "born−again" industries—are financed by commercial and investment banking institutions. There is little if any need for government subsidies or protection. However, as a re−developing country in transition, Ukraine does not yet have a strong financial sector, sound economic policies, and a fully market−oriented government. Consequently, a case can be made for some protection, but only under strict conditions.

Competitiveness is the only viable economic strategy for the long term. However, because of the physical investments, retraining, and market develoments that are needed before Ukrainian enterprises can become internationally competitive in domestic and foreign markets, some protection may be needed during the transition period.

The previous chapters demonstrate clearly that a competitiveness strategy is the only sustainable way for Ukraine to attain its objective of higher living standards for all, especially the poor. This conclusion derives from the year−long participatory process in Ukraine that led to writing this and the companion volumes of the Country Economic Memorandum series.4 The scores of representatives from government, parliament, academia, NGOs, and the private sector who reviewed these documents during a two−day conference at the end of the process confirmed that Ukraine needs to become an internationally competitive economy. The other strategic options—preservation of the status quo or protectionism—in the long run will fail.

What was strongly debated, however, was the best way to attain a competitive economy. How, they asked, can Ukraine move from its present position where a large share of the population works in farms, factories, and mines that are unable to compete in international markets without various forms of protection and government support? How can Ukraine afford to remove the tariffs, subsidies and other forms of protection that keep these enterprises open? Wouldn't this quickly destroy what little is left of the enterprises and human skills built up with decades of hard work under the Soviet regime? The Soviet system, which was funda−

4 See also *Ukraine: Restoring Growth with Equity—A Participatory Country Economic Memorandum* " and *Economic Growth with Equity: Ukrainian Perspectives* . Washington and Kyiv: World Bank, Government of Ukraine, and International Center for Policy Studies.

mentally flawed and collapsed of its own internal inefficiencies, cannot be restored and preserved. But if the existing enterprises are not protected, won't they fail, leaving hardworking people in the street to starve? How could government possibly afford to feed all of these people? Isn't it better to keep them working in the failing farms and factories, the participants asked, until better jobs are available? By what process can Ukraine convert its inefficient, non−competitive, poverty−stricken economy into an efficient competitive economy where all enjoy higher standards of living?

These are good questions that deserve good answers. It is easy to say from a comparative statics perspective that the current situation in Ukraine is bad and that having an internationally efficient economy would be good, but the dynamics of moving from one state to another can be difficult. This paper does not have room to develop detailed tactics for Ukraine's efficient and socially responsible transition to an internationally competitive economy. What we will do, however, is to examine guidelines useful for developing such tactics. After a brief recap of the risks of protection that need to be avoided, this chapter examines the dynamic dimensions of the transition process, net present value (NPV) analysis as a test of specific proposals for protection, market failures as a justification for transitional protection if the NPV test can be met, and specific policies that can be used to limit the dangers of protection.

Arguments Against Protection

While protectionism may have attractive short term results, experience around the world has shown that, after a relatively few years, it tends to destroy prospects for growth for the following reasons:

First, it allows loss−making, value−destroying enterprises to stay in business, draining away the resources that are urgently needed for investment in efficient, value−creating enterprises that can raise living standards.

Second, protection tends to create a vicious downward spiral. Protected industries, freed from the pressures of competition, have little incentive to become more efficient. Often, in fact, they become less efficient over time, demanding more and more protection, and inflicting ever−rising costs on domestic consumers.

Third, protection breeds corruption. The financial benefits of obtaining protection—though tariff barriers, tax privileges, preferential state procurement, low−cost loans, or any other mechanism—are so valuable that enterprise managers will pay substantial bribes, directly or indirectly to obtain them.

Fourth, in addition to undermining the moral fabric of society, such corruption breeds inefficiency. Investors tend invest not in the most efficient industries, but in the most highly protected industries—which are often the least efficient.

With so many arguments against protection, why would this paper even suggest that there might be a role for protection in Ukraine's future growth strategy? How can protection be reconciled with the fundamental principle, accepted around the world for nearly 200 years, that an economy prosperous best when it produces and exports the goods and services where it is relatively most efficient—its areas of "comparative advantage"—then imports those that can be produced more efficiently elsewhere. The answer lies in the fact that transition is a dynamic process.

Transition and Comparative Advantage as Dynamic Processes

Without economic development, countries would be locked into their current static areas of comparative advantage. With economic development, areas of comparative advantage change over time. From America to Europe to South Asia we see countries that have moved from exporting agricultural products like wheat, and industrial products like textiles and iron, to exporting high tech electronic goods and financial services as their areas of comparative advantage developed over time.

When the transition process in re−developing countries like Ukraine goes well, it is accompanied by profound economic changes, and these will bring dynamic changes in areas of comparative advantage. Ukraine has demonstrated a static comparative advantage today in exporting black metals and raw agricultural products—but we see clear reason to believe that, given the high standards of technological education in Ukraine and national expertise that was built up over many years in areas such as aerospace and armaments, Ukraine could develop new areas of comparative advantage at a reasonable cost. It has a potential comparative advantage in such areas from a dynamic rather than static perspective.

We know from the discussion above that a competitive economy brings the best results, but the process of moving from the current situation to this ideal state will inevitably involve compromises and trade−offs driven by the imperfections of the Ukrainian economy today. When a dam must be drained, we don't blow it up—rather we drain the water out as quickly as possible without causing collateral damage. "Shock therapy" can work very well in countries like Estonia and Poland that already had many of the social and economic preconditions for a competitive economy—countries where you can safely "cut the tail off the dog in one stroke rather than many", but radical and immediate change can cause serious social and economic problems in countries that are further from the competitive, market−based ideal.

For example, if a purely competitive model were applied immediately in Ukraine today, many of its high−tech factories would have to close their doors because their products are not currently competitive. In some cases, this is exactly what should happen for reasons noted below. However, in other cases, valuable skills could be lost as engineers and technicians emigrated to other countries. Replacing these skills could require waiting

for a new generation of engineers, a slow and costly process. Also, if the losses are less than the cost of social assistance, it may be cheaper to provide the protection needed to keep the factory open. From a social perspective, there is also value in people having a job rather than being on welfare. "Social capital"—the factors that create trust, community participation and political legitimacy—is an essential component of growth. War−torn countries demonstrate the devastating effects of the loss of social capital on economic development and social welfare. Maintaining this social capital may justify a certain amount of government support.

Like all other countries, Ukraine's policies today are a mix of preservation, protection, and competition. Even the most "competitive" economies like the US and Japan have significant protectionist elements, with some people placing more value on preserving the status quo than on trying new ideas. Ukraine will probably never choose a growth strategy that is purely competitive. But the long term strategic objective of competitiveness should always be the criterion against which any tactical policies are evaluated. Do the tactics help or hinder Ukraine in moving towards its chosen long−term goal?

The remaining sections of this chapter address ways in which Ukraine can determine when some degree of protectionism might be justified within a strategy focussed on competitiveness as a transitional measure and ways to minimize the risks of such protection.

When is Protection Justified—and When is it Not?

The argument for some modest, well−designed protection as a transitional measure to develop a new area of comparative advantage is essentially the same as the argument for educating our children. Without education, their comparative advantage would be to work as manual laborers. However, if they obtain a good education, the increase in their future incomes will more than repay the cost of their education, together with all the other costs of raising children rather than sending them out to work at an early age as happens far to frequently among the poor in developing countries. The value of increased earnings over our children's lifetimes, even when discounted to the present, is more than enough to compensate for the present cost of providing them an education. In other words, this "investment" has a positive "net present value" or NPV.5

5 Economists "discount" future earnings to the present because money received in the future is less valuable than the same amount of money received today. For example, if an investor has $100, he can invest it today at perhaps 10 percent per year and in 10 years will have almost $260. Similarly, in "net present value" terms, an investment in a factory of $100 today would have to produce the equivalent of a one−shot benefit of $260 10 years from now if the "opportunity cost" of capital and thus the discount rate is 10 percent per year. Otherwise, the investor would be better off to put the $100 in the bank at 10 percent. (In practice, additional factors must be taken into account such as the timing of future benefits if they are not all received at the end of the period and

(footnote continued on the next page)

The same can be true for "infant industries"—and for aging Soviet enterprises that need to be "born−again" to become competitive in today's global economy. In terms of figure 10, if the NPV of the losses between the time of startup (S) and the breakeven point (B) is less than the NPV of the profits between the breakeven point and the end of the project's life (E), protection may be justified if this is the only way to cover the financing of the short−term losses because of market failures or other institutional constraints.6 This test becomes increasingly hard to meet, however, when (a) the opportunity cost of capital is high (which sharply diminishes the present value of future profits), (b) the startup costs are high, (c) the time before breakeven is delayed, and (d) the future benefits are modest. If an enterprise has no realistic prospects of producing substantial profits in a timely manner, it should almost certainly be closed as quickly as possible, freeing the workers and facilities for more productive use.

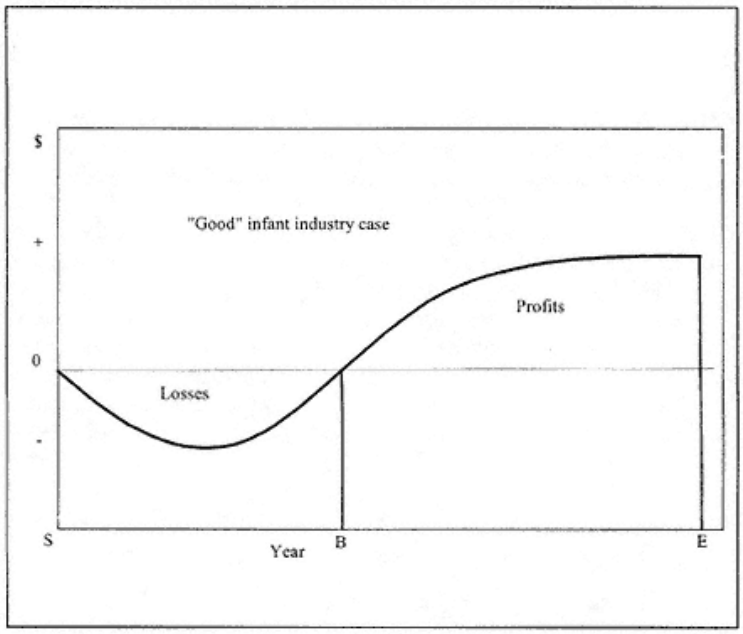

Figure 10
Protection may be justified if future profits outweigh short−term losses

Protection can be evaluated just like any other form of investment expenditure. The only real difference is that the cost of protection is borne by society at large rather than by the investor. Since the investor, not society, gets most of the benefits from an investment, it is very important before

(footnote continued from the previous page)

the residual or scrap value of the investment at the end of the period, but techniques for handling such problems are well−known and relatively straight−forward.)

6 Technically speaking, the "losses" should be titled "negative net cash flows" and the "profits" as "positive net cash flows." For example, the negative cash flow in the early part of the project's life would consist in large measure of the investment costs during the startup period, and part of the positive cash flow in the later years would be not profits but depreciation allowances to recover the cost of the initial investment.

offering protection to make sure that the returns to society will large enough to offset the costs to society.

In Ukraine, the Daewoo−Avtozaz plant is a good example of the potential problems of protection.7 Once full production is reached, the protection given to this plant could cost the Ukrainian people several thousand dollars per month per job protected. This cost would come primarily in the form of higher costs for imported cars, higher costs for domestically produced cars, and taxes that others must pay because of the tax privileges given to the Daewoo−Avtozaz plant. Other benefits from the plant might be identified in terms of inter−industry linkages, but since the average wage in Ukraine at the time these calculations were done was less than $100 per month (and only about $50 by mid−1999 following the exchange rate devaluation), this looks like a bad deal for the Ukrainian people in terms of the return they get from the protection for which they are paying. Prospects for a positive NPV on this "investment" are further clouded by the fact that world−wide excess capacity in motor vehicle production makes it hard even for long−established high−volume assemblers to show a profit. This example, which was developed in more detail in the box 3, provides clear evidence of the importance of doing careful economic analysis before extending protection to an industrial enterprise.

If Ukraine were to follow a purely competitive model today, offering no protection of any kind to any loss−making enterprise, large numbers of enterprises would have to close their doors. In many cases, this is the only sensible solution. The worst enterprises were built years ago to produce goods that could only be sold in yesterday's Soviet markets. They were never equipped to produce goods that could be sold in today's global markets—and their old soviet−style equipment is now decapitalized beyond repair in many cases. Such enterprises should in probably be closed, freeing the land and the workers for a more productive use. It may well be far more cost effective to protect the workers from such plants though targeted social assistance than by covering the losses of these value−destroying factories.

Ukraine has another large group of enterprises that could become internationally competitive and profitable with adequate investments in management, workers, capital equipment, and markets. Such investments could yield positive NPV. Some of these enterprises are already competitive and able to export at today's exchange rates, but only at wage rates that are not far above the poverty line—if the wages are paid at all. Others survive only because they also fail to pay energy and tax bills—or pay at highly concessional rates. Even under the best of conditions, most of these enterprises would probably require 24 years of restructuring and rebuilding before they could be "born−again.". The process of re−training workers and managers, re−equipping factories with modern equipment, and developing markets for the output of these revitalized enterprises

7 See the box on Daewoo−Avtozaz in chapter 6.

cannot be done at the stroke of a pen—several years may be required before the enterprises can be made ready to face global competition. But if the enterprise has long−term potential viability, the cost of the investment today will be far outweighed by the future stream of profits, even when discounted to the present. Some protection may be justified to keep such enterprises operating until they become competitive, thus preserving labor skills and physical assets, but such protection should be given only under very stringent conditions.

The protectionist strategy is often defended on equity grounds. But, while diffuse, the costs to consumers are usually greater than the benefits to protected plants and workers

The NPV analysis provides an excellent tool for determining the best approach in such eases and should become a standard test applied to all cases of protectionism, both existing and new. Protection should be granted, if at all, only when the NPV to the country at large is positive.

The NPV analysis needs to be done from the perspective of the entire Ukrainian economy and society, not just from the perspective of the sector or enterprise being protected. The analysis needs to be done in economic and social as well as in financial terms. For example, by raising the selling price, protection could make the projected NPV of an enterprise positive as measured in terms of the enterprise's financial accounts. However, by discouraging the import of products that are better and cheaper, this same protection imposes costs on the people of Ukraine in the form of higher prices and lower quality. The real value of the output from an economic perspective—from the perspective of the economy as a whole—is the lower price that the Ukrainian people would have to pay to import a similar product from abroad.8 Valuing the output at this price would reduce the positive cash flow figures, possibly resulting in a negative NPV and thus a decision that the activity should not be protected. Conversely, if the enterprise needs protection because it has to pay for inefficiently produced domestic steel and other inputs, the NPV analysis should take this into account by valuing the inputs at the "border price"—the lower price that the enterprise would have to pay for the inputs if it were allowed to import them at world prices. This lower cost would raise the NPV result, perhaps indicating from an economic perspective that some protection is temporarily justified to offset the high cost of domestically produced inputs.9

8 The techniques of economic benefit−cost analysis are highly relevant here. Although traditionally applied to the appraisal of specific investment projects, these techniques can be most helpful in deciding whether or not a given sector or industry should be protected. In this technique, the market prices used in financial analysis are replaced with "shadow prices" based on "opportunity costs" such as the cost of imported inputs as an alternative to high−cost domestic inputs to produce an economic assessment, the results of which can be expressed, as they are here, as an economic net present value, or as an internal economic rate of return. Ideally all inputs and outputs should be valued at their opportunity cost in doing such an analysis, but in practice it is usually sufficient to revalue only the major inputs and outputs (ref. J. Hansen, *Guide to Practical Project Appraisal: Social Benefit−Cost Analysis in Developing Countries* . Vienna/New York: UNIDO, 1978).

9 Even better than providing protection to the consuming enterprise would be to remove protection on the supplying enterprise, forcing it to reduce its costs to world

(footnote continued on the next page)

Economic analysis can be extended further, taking into account explicitly social issues. Protection may generate significant social as well as economic benefits. In fact, social benefits are one of the main reasons that governments implement protectionist policies. For example, if modest protection allowed a factory to stay open, thus enabling it to continue paying taxes and avoiding the cost to the government of providing social assistance

payments to the workers, these savings to the government should be included as a positive element in the prospective cash flows. Particularly in small towns dependent on one or two "town−forming" enterprises, protection may be justified because of the social value of avoiding plant shutdown, something that could hurt other businesses and create social problems throughout the community. Such impacts are hard to measure, however, and it is therefore probably best to use the cost of social assistance payments that would be avoided because of protection as a proxy for the social benefits of protection. Such payments would be sufficient to allow the workers to continue patronizing the shops and other services that depend on the factory, thus reducing (though certainly not eliminating) the knock−on effects of plant closing.10

Do Market Failures Justify Protection?

Most claims for protection come from enterprises facing substantial short−term negative cash flows and uncertain positive cash flows in the future—the "losses" and "profits" respectively in figure 10. An enterprise should not be protected if the NPV of its prospective cash flows is negative due to its internal problems—physically inefficient production processes or low quality products with little or no demand on the market that make it impossible to sell future output at prices sufficiently high to compensate for startup costs. However, if the negative NPV is the result of problems external to the enterprise, protection may be justified on the basis of "market failures". Some of the most frequent market failures are

(footnote continued from the previous page)

levels through improved efficiency. But this may or may not be possible in the short run. To determine the appropriate strategy may require applying the NPV analysis along the lines developed here to the supplying industry.

10 The literature on benefit−cost distinguishes social from economic analysis on the basis that social analysis takes into consideration the distribution, something that does not enter into the economic analysis per se. Social assistance payments are clearly an income distribution issue. The funds are taken from the population at large through taxes and distributed to the poor—explicitly a form of income redistribution. The question then becomes, is it more efficient (a) to follow the purely competitive model and protect the people potentially hurt by factory closings by having the government redistribute money to them through the tax/welfare mechanism, or (b) to use protection and have the money be transferred to the (potentially) poor from consumers who, all other things being equal, would pay lower taxes but pay higher prices for the goods they consume? Which is more efficient, the tax/spend mechanism of the government, or the protect/pay mechanism of the market? The same questions should be asked about supporting the people would remain unemployed if infant industry protection were not granted to startup factories. Each case needs to be decided on its own merits in line with these basic principles.

the failures of institutional development, information flows, government policies, and externalities.

Institutional Failures

Internationally competitive production depends not only on the internal efficiency of enterprises, but also on the efficiency of institutions in the economy. Without support from efficient institutions, enterprises are likely to fail. To be efficient, enterprises need efficient banks, legal systems, tax regimes, trade policies, suppliers, and the like. In re−developing economies like Ukraine where old institutions suited to a command economy must be replaced by new market−oriented institutions as part of the transition to a market economy, enterprises often find that "institutional failure," the failure for such enterprises to develop in a timely manner, forms an important barrier to efficient production.

Take banks, for example. If markets were perfect and the banking system well−developed, commercial banks would come forward and finance any enterprise which could demonstrate that an investment in restructuring today would provide a positive NPV at the interest rate charged by the bank. Instead of demanding government subsidies and tariff protection, which are paid for by people throughout the country, the enterprise would take out a loan sufficient to cover the negative cash flow in the early phases of the project, borrowing to cover both the physical investment costs and the losses incurred because of higher−than−normal costs and slow sales during the start−up phase of production. Once the enterprise passed through the learning curve and was operating at full capacity, production costs would fall below the internationally competitive price, profits would increase, and the loan could be repaid with interest. In other words, the enterprise would meet the NPV test.

Market failures such as unrealistic perception of risks, inadequate information, and externalities can possibly justify some government support and protection. Wherever possible, however, the market failures should be corrected rather than providing compensation through protection.

In the normally functioning market economies of Europe and the US, this is exactly what happens—which explains why new enterprises are able to start up and ultimately prosper even though average tariffs in these countries on industrial products are miniscule. The capital market institutions in these countries are well developed, including not only commercial banks, but also investment banks and venture capital firms that specialize in financing riskier start−up ventures.

In Ukraine and many other developing countries, however, institutional failures in the banking system can prevent firms with good long−term prospects from getting adequate financing for start−up costs. Banks not accustomed to working in a market environment commonly overestimate the real risk of lending. They lack experience in lending to smaller, non−government enterprises; they do not know the economics of the sectors; they do not know the enterprise investors and managers; and they do not have the staff needed to monitor the financial performance of borrowers during the life of the loan.

Potentially viable firms in rural areas face even greater problems because they do not have ready access to a strong banking network. The larger banks with more adequate capital and human resources tend to be located in the major cities of Ukraine, making it very difficult for enterprises outside of these urban centers to get the financing that they need. A tendency towards "satisficing" rather than "maximizing" behavior leaves the bank managers happy to limit their business to the old established firms, particularly those in urban areas that enjoy and explicit or implict government guarantees—even if those firms have far less economic potential than the new private enterprises. Until the debt servicing crises and restructurings of t−bills during the past year, the unwillingness of banks to lend to commercial ventures was increased by the ease of buying t−bills at real interest rates well over 50% per year.

Institutional failures are by no means limited to the banking system. In Ukraine production costs are increased and net returns are reduced by problems such as the lack of a court system that can effectively enforce contracts for payment (including through the threat of bankruptcy), the government's inability to control widespread corruption including that among tax and customs inspectors, and the lack of a stable legal framework, especially in the area of taxation. Furthermore, Ukraine has yet to develop the same kind of institutions that support efficient production and distribution in other countries such as a network of support services including accounting, advertising, shipping, and consultancy.

Compensating for institutional failures through protection can be very risky because it is difficult to predict when the institutional failures will be resolved. In most cases it is probably better to focus the nation's resources on improving the efficiency of institutions than to spend resources on offsetting their inefficiency. For example, better court and legislative systems can be put into place, including an effective bankruptcy law and the means to administer it. The administration of tax and customs can be modernized and cleared of corrupt elements. Training

programs can be established for banks to help their staff learn how to evaluated normal commercial risks.

Information Failures

Information failures are found throughout Ukraine today, increasing the cost and adding to the risks of producers. The lack of information in local banks about producers and sectors that discourages them from lending to startup ventures was noted above. Producers do not have adequate information regarding optimal technologies, potential suppliers, and prospective markets. Because of poor gazetting, information about the laws within which enterprises are supposed to operate is hard to get, leaving them open to fines, penalties and extortion.

As with institutional failures, it is usually more cost effective to improve the flow of information than to try to compensate producers for these failures with protection. For example, information failures can be par−

tially overcome through government−sponsored business development centers that help entrepreneurs prepare project proposals, thereby providing lending institutions the information they need in a form with which they are familiar. These same centers can provide sectoral investment and marketing information to potential entrepreneurs and financiers, reducing the risk of information failure as a source of market failure.

Policy Failures

Especially in the past, but still to some extent today, an important market failure in Ukraine has been the failure to allow market forces to determine the *exchange rate* and the *prices* for producers inputs and outputs. In a vain attempt to keep the exchange rate stable despite domestic prices that were rising much more rapidly than prices in trading partner countries, the government and the central bank imposed numerous non−market measures designed to limit the demand for foreign exchange and to increase its supply. The latter included heavy external borrowing to cover domestic debts of the government. As a result, the value of the domestic currency was kept artificially high, making it difficult for Ukrainian producers to compete with imported goods on the domestic market or to export to foreign markets. This in turn destroyed profitability, making it hard for them to pay suppliers, workers, banks, and taxes.

The non−payment of taxes created a feedback mechanism, leading to lower government revenues, higher deficits, and even more foreign borrowing, thus exacerbating the overvaluation of the domestic currency. Enterprises called for protection from imports to help compensate. This is the wrong approach, for it does nothing to make Ukrainian exports more competitive. The only sensible solution is to solve the market failure—to allow the price of foreign exchange to be set by market forces.

Markets should likewise be allowed to establish the prices for the goods and services consumed and produced by enterprises. The Ukrainian government has a good record in recent years in terms of avoiding direct price controls, but it does interfere indirectly through mechanisms such as tariff and non−tariff restrictions on the export of products like sunflower seeds. At the local level, prices are distorted by measures that prevent the free movement of grain and other agricultural products. These policies cause market failures that can make it difficult for enterprises to survive, but as discussed below, protection is a bad way to correct the problem.

The *high cost of capital* in Ukraine, which commonly leads enterprises to cry out for subsidized loans, is another policy failure. The high cost of domestic capital in Ukraine is driven in large part by the government deficit and its financing requirements. The deficit has come down sharply in recent years, which is much to the government's credit, but refinancing of the debt accumulated in previous years still forms a major claim on Ukraine's total financial resources.

If the government had been subject from the outset to the market forces that apply to any enterprise and to most governmental bodies in well−functioning market countries, it would have been forced to reduce its deficit spending much earlier or face bankruptcy. But the Government of Ukraine initially placed itself outside normal market controls, printing money to finance its deficits after independence, then later borrowing far beyond prudent levels in both domestic and foreign capital markets. In the end, of course, these attempts to avoid market forces failed, and now the market demands a very high price for lending to Ukraine—and recently has refused to lend at all. The government's financing requirements have thus been a major factor behind the high cost of capital facing Ukrainian entrepreneurs.

Until the costs are brought down to levels in real terms similar to those available to entrepreneurs in other countries, Ukraine will not see the investment needed to restore growth and living standards. Current efforts to overcome the problems of the past by restructuring the stock of debt and reducing new financing needs by imposing tight controls on the budget deficit are the best way to solve this problem. Protecting enterprises by subsidizing loans to them to compensate for the high cost of domestic capital would simply add to the government deficit, creating even higher domestic capital costs.

Externalities

Another market failure—one that is widely used and abused as an excuse for protectionist policies—is "externalities." Projects are frequently claimed to have benefits that are external to their accounts and thus not available to help repay costs. The Daewoo−Avtozaz plant in Ukraine is a good example. The government has justified the extensive and very costly protection and privileges extended to this factory on the basis that it has backwards and forwards linkages with large multiplier effects on the rest of the economy. For example, it will provide markets for the output of the domestic metal and machine building sectors.

However, it is not enough to show that a given project such as Daewoo−Avtozaz has linkages such as providing markets for supplier industries. Most projects have some form of linkages that stimulate economic activity and growth beyond the factory walls or the farm gate. But are these linkages more valuable and do they create greater externalities than alternative investments would? For example, the money that went into the Daewoo−Avtozaz plant could have gone instead to create a facility for the high−volume, efficient production of high−value automotive components such as transmissions or sound systems that could be shipped to assembly plants all over the world. This would have produced externalities for the domestic metal and machine building industries that were at least as im−

portant as those likely to come from the Daewoo plant, and the requirements for protection and subsidization would have been far less.11

Any claims of externalities must also recognize that the incremental activity in other sectors will almost certainly involve additional costs including major investments in new plant and equipment. This is clearly the case in Ukraine. Most metal production, for example, is highly energy intensive compared to that of competitors in today's global markets. Ukraine exports large amounts of black metal on these markets, but it is not at all clear that these exports would be possible if the factories were forced to pay cash in full and on time for the real value of the energy consumed as well as their tax and wage bills. To the extent that a project like Daewoo−Avtozaz stimulates additional production of steel and other inputs by firms that are loss−making in economic terms, the externalities of the project are actually negative, making it even more difficult to justify.

The Daewoo−Avtozaz venture was justified on the basis of externalities not only to other production sectors, but also to government: protecting the factory would save money for the government, which would not have to provide welfare support for 20,000 workers. In the case of this plant, the argument appears without foundation. First, the monthly cost of protection at full production for each job protected in the factory would be enough to

provide welfare payments to 50100 workers. Conversely, making the welfare payments directly would cost roughly 12 percent of supporting them through protectionist measures. Second, it is easy to put a limit on the duration of welfare payments, and people will normally find a new job rather than stay on welfare. In contrast, experience in other countries indicates that protection costs go on for years and commonly rise over time due to increasing inefficiency in the absence of effective competition.

In short, externalities are just as likely to be negative as positive in the current Ukrainian environment, and even where positive in gross terms, are likely to be much smaller in net terms after the costs in other areas are counted. Aside from some probably rare cases where the cost of the protection needed to keep an enterprise in operation is less than the cost of the welfare costs of supporting the dismissed workers, claims of a market failure due to externalities is unlikely to provide a persuasive basis to argue for protection.

When any of the market failures listed above are present, the best approach is almost always to fix the failures rather than to compensate through protectionist actions. A competitive banking system should be encouraged through prudential regulation and supervision according to international standards. Supporting institutions such as accounting, ad−

11 To avoid potential negative externalities such as encouraging inefficient production of domestic inputs like steel, it is important to have a liberal external trade regime so that the domestic producers face potential competition from efficiently−produced steel from abroad, thus encouraging them to become equally efficient.

vertising and shipping firms in the private sector should be encouraged by creating a good business climate Information failures can be corrected through appropriate programs like those introduced by many of the East Asian countries that were serious about developing internationally competitive export sectors. Such policies are clearly a first−best solution compared to protection. These policies, however, take time to implement, and as a strictly transitional measure, very limited amounts of protection may be justified under certain conditions to offset market failures.

How Can the Dangers of Protectionism be Minimized?

Protection should be equitable, transparent, budgeted, time−bound with automatic phase out, involve manageable downside risks, and be available only to activities that can demonstrate reasonable prospects for generating a positive NPV.

If a market failure prevents desirable investments from taking place and the failure cannot be corrected in a timely manner, a case for some protection may be made. However, to avoid the serious potential problems of protectionism, such protection should be extended only on the following conditions:

Equity—equally available to all. Any protection should be made available on equal terms to all enterprises in a similar situation. If one steel mill is to get protection (including subsidies), all should be equally entitled to it. This is essential to (a) reduce the risk of corruption, (b) discourage subsidies by making them expensive, and (c) preserve equal conditions of competition for all producers in the sector—a level playing field—thus avoiding the tendency for protection to favor the inefficient over efficient producers.

Transparency. The criteria by which any specific type of protection would be provided should be established by law (or regulation), published, and followed without exception. This is important for the same reasons that equity in the allocation of protection is important.

Budget. Any protection of a fiscal nature—including tax privileges—should be shown explicitly in the budget. Tax privileges should be entered as "tax expenditures"—a negative entry immediately below the estimated tax

revenues that would be attained if the privileges and exemptions were not granted. This makes the cost of subsidies very transparent, increasing pressures to limit the provision of such subsidies and to eliminate them as quickly as possible.

Positive net present value. As explained above, protection should never be given to any activity that cannot demonstrate beyond reasonable doubt that the investment (including protection costs) will have a positive NPV over the life of the investment.

Manageable downside risks. At this stage in the transition process, Ukraine cannot afford excessive downside risks. Even a relatively small percentage reduction in average incomes would move an large additional share of the population below the poverty line. The gov−

ernment should therefore limit protection only to those sectors with the least downside risk. For example, if the "best guess" of the expected NPV of investments in two sectors is the same, but if one is subject to a margin of error of 2% and the other to a margin of error of 20%, the activity with a 2% downside risk should be given preference—even if this means foregoing the chance of a 20% higher NPV with the other.

Time−bound with automatic phase out. One of the biggest risks of protection is that it will not only become permanent, but increase over time. The best way to control this risk is to announce in advance that each instance of protection will expire within a fixed period—usually not more than five years—and will be gradually reduced over the last three of those five, for example, so that, by the end of the protected period, the enterprise(s) will have had adequate incentive to become efficient and competitive without protection.

Summary

Most informed Ukrainians agree that competitiveness is the only viable economic strategy for the long term. However, because of the physical investments, retraining, and market developments that are needed before Ukrainian enterprises can become internationally competitive in domestic and foreign markets, some protection may be needed during the transition period.

In a well−functioning market economy with a strong financial sector, sound economic policies, and a market−oriented government, the transition costs—even for "infant" and "born−again" industries—are financed by commercial and investment banking institutions. There is little if any need for government subsidies or protection. However, as a redeveloping country in transition, Ukraine does not yet have a strong financial sector, sound economic policies, and a fully market−oriented government. Consequently, a case can be made for some protection, but only under strict conditions.

Market failures such as unrealistic perception of risks, inadequate information, and externalities can possibly justify some government support and protection. Wherever possible, however, the market failures should be corrected rather than providing compensation through protection.

If protection is to be granted—through subsidies, tax privileges, tariffs, or non−tariff barriers—such protection should be equitable, transparent, budgeted, time−bound with automatic phase out, involve manageable downside risks, and be available only to activities that can demonstrate reasonable prospects for generating a positive NPV with a relatively small downside risk. Under such conditions, a judicious use of protectionism can contribute to Ukraine's transition to an internationally competitive economy, one that holds great promise of providing higher standards of living for all Ukrainians.

9—
Facing the Challenge

We recommend that the Ukrainian Government adopt the competitiveness strategy. It provides the best opportunities to make sustainable improvements in the living standards of the Ukrainian people. This strategy will have some undesirable outcomes in the short term. But to achieve its objectives the Government needs to look beyond the immediate future. It is crucial that government officials and politicians re−focus decision−making processes away from the short term and towards a more strategic model of government.

Ukraine faces the challenge of creating sustainable growth with equity. These objectives can not be achieved easily. To rise to the challenge Ukraine must create a national consensus on a strategy for both economic and social policy. If Ukraine's policies react to short term crises on an ad hoc basis, the country will continue to stumble from one crisis to another. Problems such as wage and pension arrears and barter need to be addressed. But they must be addressed in the context of a longer−term strategy. If the government lurches from one individual problem to another, it will lose grasp on its overarching objectives.

In all countries, economic and social problems and policies are interrelated. We can not deal with these problems sequentially or separately. Ukraine can not work on the problem of arrears, then turn its attention to falls in production. With that approach, the solution to today's problems creates tomorrow's problems. For example, experience over the last few years shows that whenever the government focused on the budget wage and pension arrears, it responded with policies designed to extract more cash from enterprises. This typically had the effect of putting the brakes on business activity. After some time, the government would refocus on falling output, moving to support enterprises and reduce taxation, leading in turn to the resurgence of the arrears crisis12 .

This report recommends a strategy—the competitiveness strategy. It clearly has the greatest potential to deliver sustainable improvements in the living standards of Ukrainian people. Under this strategy, the role of government changes from the ownership and control of production to providing a stable environment for business. It should see itself as a protector of people, not of production.

This report recommends a strategy—the competitiveness strategy. Of the three strategies outlined here, the competitiveness strategy clearly has the greatest potential to deliver sustainable improvements in the living standards of Ukrainian people. Under this strategy, the role of government changes from the ownership and control of production to providing a stable environment for business where all enterprises have equal access

12 Alex Sundakov, *Transition Crisis: Is Crisis Management Delaying Transition?*, New Zealand Institute of Economic Research, Paper presented to the German−Ukrainian Symposium: "Ukraine finding its way to a market economy—lessons from an international comparison", 19/20 June 1998.

to critical inputs and markets. It includes measures such as removing protection of favored enterprises, deregulation, continued privatization and providing a transparent and predictable legal framework.

The strategy does not involve government leaving all Ukrainians to live or die at the whim of the market. While we have argued that the market is usually more effective than government at allocating resources, there are situations where markets do not work well. The market is even less able to ensure that economic prosperity is distributed fairly. The extent to which Ukraine seeks to redistribute income is, at least partly, a political decision. However, it should see itself as a protector of people, not of production. It should also seek to protect people in ways that minimize the economic cost to other Ukrainians. For example, paying direct benefits to pensioners is a much less costly and more effective way to protect Ukraine's grandparents than regulating the prices of goods and services.

The details of how to implement this strategy are not discussed in this report. Instead they are addressed in companion volumes13 . These reports should be read in conjunction. Of course, policy makers need not only a strategy, they also need a detailed guide as to how to put that strategy into practice. We can not separate the short and long−term in policy making: instead we have to take small steps towards our long−term goals.

Sometimes taking steps towards our long−term goals will initially have undesirable impacts. To adopt the competitiveness strategy, government would have to take a conscious decision to accept some short−term costs in return for placing Ukraine on a path towards higher living standards. When the government is focused only on immediate solutions to Ukraine's problems it sees the steps needed for the transition to a more market−based economy as part of the problem rather than part of the solution. Deregulation, for example, tends to have negative fiscal consequences in the short term. Allowing bankruptcies will have an immediate impact on unemployment. However, ways of lessening these impacts without sacrificing our longer−term goals can be identified (see companion volume).

It is often difficult for policy makers to focus on longer−term objectives when they are being buffeted by the problems of the day. The temptation is to find an immediate solution that will make the symptoms of the problem go away, but this rarely fixes the underlying problems. Knowing their understandable tendency to focus on the short term, Ukraine's decision−makers should commit themselves to their own medium−term strategy. For example, Cabinet of Ministers could impose a rule on itself that it will not consider any proposals unless they are accompanied by a report

13 World Bank, *Ukraine: Restoring Growth with Equity—Participatory Country Economic Memorandum* . Washington: IBRD, 1999, and Economic Growth with Equity—Ukrainian Perspective, 1999, ICPS, chapter 9.

explaining how they fit within its overall long−term strategy which may in Government now agree should be a competitiveness strategy, how they will interact with other policies, what the benefits and costs of this and key alternative policies would be, and why the recommended proposal was chosen.

In many countries, the professional civil service acts as a counter−balance to the short time horizons of the political process. Unfortunately, this function is not being performed by the government agencies in Ukraine. Delays in undertaking administrative reform have meant that the civil service is not set up to provide medium−term strategic advice to the government. Instead it too is focused on the short−term.

Therefore, for any strategy to be implemented successfully, administrative reform is crucial. The main objective of this reform should be to refocus decision−making processes away from the short term, and towards a more strategic model of government: a model that embodies a fundamental change in the role of government—a change from ownership and control to one of facilitating business and developing people. Government officials need to become accountable for pursuing activities which are not consistent with the government's policy objectives. Technical assistance also needs to be focused towards providing public servants with the skills needed to help policy−makers make good decisions.

If Ukraine does not make the effort to look beyond the immediate future, its economy will continue to stagnate or drop even further. The competitiveness strategy would ultimately reverse the cruel decline in incomes since 1990. It would allow Ukraine to move steadily closer to the goal, shared by most, of becoming a modern, self−sufficient, and even modestly prosperous member of the European Community. No unsolvable physical problems stand in the way. Ukraine has the natural resources, the educated people, and the work ethic that are needed. It simply needs the commitment to move forward on a sustainable growth path as rapidly as possible.

Recent World Bank Discussion Papers (*continued*)

No. 373 *A Poverty Profile of Cambodia* . Nicholas Prescott and Menno Pradhan

No. 374 *Macroeconomic Reform in China: Laying the Foundation for a Socialist Economy* . Jiwei Lou

No. 375 *Design of Social Funds: Participation, Demand Orientation, and Local Organizational Capacity* . Deepa Narayan and Katrinka Ebbe

Nol. 376 *Poverty, Social Services, and Safety Nets in Vietnam* . Nicholas Prescott

No. 377 *Mobilizing Domestic Capital Markets for Infrastructure Financing: International Experience and Lessons for China* . Anjali Kumar, R. David Gray, Mangesh Hoskote, Stephan von Klaudy, and Jeff Ruster

No. 378 *Trends in Financing Regional Expenditures in Transition Economies: The Case of Ukraine* . Nina Bubnova and Lucan Way

No. 379 *Empowering Small Enterprises in Zimbabwe* . Kapil Kapoor, Doris Mugwara, and Isaac Chidavaenzi

No. 380 *India's Public Distribution System: A National and International Perspective* . R. Radhakrishna and K. Subbarao, with S. Indrakant and C. Ravi

No. 381 *Market−Based Instruments for Environmental Policymaking in Latin America and the Caribbean: Lessons from Eleven Countries* . Richard M. Huber, Jack Ruitenbeek, and Ronaldo Serôa da Motta.

No. 382 *Public Expenditure Reform under Adjustment Lending: Lessons from World Bank Experiences* . Jeff Huther, Sandra Roberts, and Anwar Shah

No. 383 *Competitiveness and Employment: A Framework for Rural Development in Poland* . Garry Christensen and Richard Lacroix

No. 384 *Integrating Social Concerns into Private Sector Decisionmaking: A Review of Corporate Practices in the Mining, Oil, and Gas Sectors* . Kathryn McPhail and Aidan Davy

No. 385 *Case−by−Case Privatization in the Russian Federation: Lessons from International Experience* . Harry G. Broadman, editor

No. 386 *Strategic Management for Government Agencies: An Institutional Approach for Developing and Transition Economies* . Navin Girishankar and Migara De Silva

No. 387 *The Agrarian Economies of Central and Eastern Europe and the Commonwealth of Independent States: Situation and Perspectives, 1997* . Csaba Csaki and John Nash

No. 388 *China: A Strategy for International Assistance to Accelerate Renewable Energy Development* . Robert P. Taylor and V. Susan Bogach

No. 389 *World Bank HIV/AIDS Interventions: Ex−ante and Ex−post Evaluation* . Julia Dayton

No. 390 *Evolution of Agricultural Services in Sub−Saharan Africa: Trends and Prospects* . V. Venkatesan and Jacob Kampen

No. 391 *Financial Incentives for Renewable Energy Development: Proceedings of an International Workshop, February 17−21. 1997, Amsterdam, Netherlands* . E. Scott Piscitello and V. Susan Bogach

No. 392 *Choices in Financing Health Care and Old Age Security: Proceedings of a Conference Sponsored by the Institute of Policy Studies, Singapore, and the World Bank, November 8, 1997* . Nicholas Prescott, editor

No. 393 *Energy in Europe and Central Asia: A Sector Strategy for the World Bank Group* . Laszlo Lovei

No. 394 *Kyrgyz Republic: Strategy for Rural Growth and Poverty Alleviation* . Mohinder S. Mudahar

No. 395 *School Enrollment Decline in Sub−Saharan Africa: Beyond the Supply Constraint* . Joseph Bredie and Girindre Beeharry

No. 396 *Transforming Agricultural Research Systems in Transition Economies: The Case of Russia* . Mohinder S. Mudahar, Robert W. Jolly, and Jitendra P. Srivastava

No. 398 *Land Reform and Farm Restructuring in Moldova: Progress and Porspects* . Zvi Lerman, Csaba Csaki, and Victor Moroz

No. 400 *Russian Enterprise Reform: Policies to Further the Transition* . Harry G. Broadman, editor

No. 401 *Russian Trade Policy Reform for WTO Accession* . Harry G. Broadman, editor

No. 402 *Trade, Global Policy, and the Environment* . Per G. Gredriksson, editor

No. 403 *Ghana: Gender Analysis and Policymaking for Development* . Shiyan Chao, editor

No. 404 *Health Care in Uganda: Selected Issues* . Paul Hutchinson, in collaboration with Demissie Habte and Mary Mulusa

No. 405 *Gender−Related Legal Reform and Access to Economic Resources in Eastern Africa* , Gita Gopal

No. 407 *Economic Growth with Equity: Ukrainian Perspectives* , John Hansen and Vira Nanivska, editors